

A Private Affair

The \$17B buyout of Harrah's unleashes new force in casino industry investment

By JAMES RUTHERFORD
International Editor

The word from official and unofficial circles is the sale of Harrah's Entertainment will not halt the casino giant's plans to invest upwards of US\$1.9 billion in expansion outside the United States.

"I think it's safe to say the company will continue to pursue growth," said one source close to the \$17 billion deal that took Harrah's off the New York Stock Exchange in December and into the hands of U.S.-based private-equity powerhouses Texas Pacific Group and Apollo Management. "It's full speed ahead."

Harrah's management has been quoted in several news reports essentially affirming this assessment. CFO Jonathan Halkyard told the *Las Vegas Sun*, "Internationally we don't expect [the purchase] to influence any plans."

In Spain, Harrah's holds a 60 percent stake in a \$670 million development planned for a new resort enclave in Ciudad Real province a couple of hours by auto or train between Madrid and Seville. The 40 percent partner is a Spanish company called El Reino de Don Quixote de La Mancha, which is the name of the master-planned community the two are developing. The resort will market to a Europe-wide clientele with an array of hotels, golf courses, spas, shops, convention and conference facilities and a 50,000-square-foot Caesars casino with an 850-room hotel and a 3,000-seat theater.

In Slovenia Harrah's has entered a 50-50 partnership with HIT Group, the country's largest casino operator, on a \$700 million development in Nova Gorica near the Italian border, where HIT already operates two casino hotels. Plans call for a 48,000-square-foot casino, a hotel with between 800 and 1,200 rooms, convention and conference facilities and a range of resort-style amenities. There are a couple of sticking points to this deal, however. One is a law that limits foreigners to ownership of no more than 20 percent of any Slovenian gambling venture. The other is the country's 30 percent tax rate, which Harrah's reportedly wants reduced by half.

In Britain there is Harrah's purchase of London Clubs International, a transaction valued at \$570 million, or about 290 million sterling. "This is an entree into Europe for a company that can leverage that into a lot of other things. With deregulation it's a smart move," said Matt Sodl, managing director of Innovation Capital, an investment banking firm active in mid-market casino industry M&A.

LCI is Harrah's second stab at the UK. The first, a partnership with Gala Group, foundered when opposition in Parliament blocked Government plans for dozens of Las Vegas-style casinos. With LCI Harrah's gets seven operating casinos in England, four of them in London, and three casinos in Egypt and South Africa that more likely than not will be sold. LCI is especially attractive for the five new casino licenses it has secured in England and Scotland, one of these for a 40,000-square-foot venue scheduled to open next month at Leicester Square in London's West End.

"A good international diversification play," said a knowledgeable source. And so it would seem, looking ahead to the reforms enacted in 2005 that are opening Britain's traditionally staid casino industry to the mass market.

In the Bahamas Harrah's has a 33 percent stake in a \$1.6 billion development near Nassau that investors say will be the largest destination resort in the Caribbean. It is called Baha Mar and is scheduled for completion in 2010 with six hotels, a 20-acre beach, a golf course, a water park, convention and meeting space, 50,000 square feet of retail, restaurants and entertainment venues and other attractions. Harrah's end is a 95,000-square-foot Caesars casino with a 1,000-room hotel. The majority stakeholder is a Bahamas-based developer called Baha Mar Resorts. Starwood Hotels & Resorts Worldwide has a 10 percent share.

The transaction economy

Needless to say, a lot can happen over the course of the next several months as Harrah's and its new owners work to complete the largest leveraged buyout in gambling industry history (and the seventh-largest of all time), with all that implies. Regulators have never encountered a transaction with this many pieces before. Harrah's is the largest casino operator in the world with \$21 billion in assets comprised principally of 39 resorts in 12 U.S. states and in Canada and Uruguay. All these entities have to register their approval, and figuring how many people affiliated with Texas Pacific and Apollo are required to undergo licensing will of course be a critical part of this process.

"If you're a regulator it's going to change your world," said Sodl.

Harrah's also has a massive amount of investment on its U.S. drawing board. This includes more than \$1 billion in projects still in development in Atlantic City and Indiana. But the most important piece of the U.S. puzzle is what to do with some 125 prime undeveloped acres the company owns around its seven casinos on the Las Vegas Strip. This is the casino industry's ground zero, Harrah's values this land at \$13 million an acre, and it's surrounded by deep-pocket competitors like MGM Mirage, Las Vegas Sands, Wynn Resorts and Boyd Gaming who are investing billions on the Strip. Harrah's has yet to announce its

plans on the Strip, due in no small part to the fact that it's still digesting the far-flung holdings of Caesars Entertainment, which it bought not 20 months ago for more than \$9 billion.

What is certain is that Apollo and Texas Pacific will take a keen interest in what happens there.

"The attraction for them is the amount of real estate Harrah's controls," said Brian Gordon of Applied Analysis, an economics advisory firm based in Las Vegas. "The acreage on the Strip is significant, and pricing points demonstrate there are premiums being applied to it. They see an opportunity to leverage the value of that real estate."

It was "the real estate value of the assets" that inspired private equity's move on Harrah's, said Sodl.

"These are deal-driven guys who are all about delivering returns for their investors."

The other big issue is debt. As expected with an LBO of this magnitude, Harrah's debt ballooned overnight, growing from \$10.7 billion to \$21 billion - from about four times estimated 2007 EBITDA to eight times. The ratio of debt to equity (which in Harrah's case correspondingly has shrunk by half) is now about 75:25, which is not so good for the bondholders. In essence the company is funding its own acquisition by putting up its assets as collateral. This is, however, the way LBOs work, and Harrah's new capital structure is not out of line with the average for transactions of this sort.

"Actually, it is similar to what we see in the public markets, and in terms of the merger transactions that have taken place with some of the biggest companies, the MGM Mirages of the world, and the multinationals," said Mark Harms, CEO of investment bankers Global Leisure Partners, speaking last October to the annual conference of the International Association of Gaming Regulators. "Most of the public companies in the U.S. were built on the back of high-yield debt, so the industry is very used to seeing leverage. It's probably one of the best industries in the world in terms of leveraged financing."

Debt is the basis of the very impressive returns private equity has generated for its institutional investors over the last several years - 20 percent and more on a compound annualized basis, according to some sources, 33 percent, according to Harms, which is almost double that of the hedge funds, almost three times greater than the public markets - and the source of the hefty dividends and fees fund managers routinely extract from their portfolios.

Because it is largely free of the restrictions and scrutiny that dog the public markets, private equity is able to fully exploit the logic which holds that capital structure has little affect on return on assets. Given that returns above and beyond the cost of capital, which in the case of LBOs is relatively fixed, flow through to the equity, and that income flowing to equity is taxed while interest payments are not, debt actually increases the value of target companies, thus enabling you to pay higher prices for acquisitions. This happy state of affairs is driving creative minds to develop ever more sophisticated and complex credit engines in the form of mortgage-backed securities and things like "collateralized loan obligations" in which separate pieces of mostly speculative-grade bank loans are bought, pooled and repackaged as high-grade paper and widely dispersed to spread risk.

It's like having a license to print money, when you think about it, and it's a big part of the reason the world is awash in capital right now and the stuff is cheaper than it's ever been. So even as the collective debt level soars demand continues to outrun supply, with the result that risk is looking about as good as it ever has. And why shouldn't it. The default rate for speculative-grade investments hit a 24-year low in the United States in 2006, according to Standard & Poor's. While the previous year saw only 23 defaults on more than \$36 billion of fresh borrowing. In Europe default rates stabilized last year at an amazing 1.08 percent. All the demand is driving down yields, of course; but who cares when even debt rated CCC+ or lower is returning averages exceeding 11 percent. Not surprisingly, U.S. companies rated CCC or lower were able to float well more than \$30 billion of bonds last year, more than double all of 2005.

Private equity, for its part, accomplished something like \$300 billion in deals last year. LBOs accounted for about 27 percent of all U.S. mergers and acquisitions. Citing Standard & Poor's, *BusinessWeek* reckoned that in the last three years, banks have funneled some \$71 billion in loans through U.S. companies to pay dividends to private-equity owners, up from \$10 billion for the preceding six years.

How much leverage the corporate world can ultimately bear is another question. Critics say a reckoning is inevitable. For now, though, there are fortunes to be made in the transaction economy. The London Stock Exchange opened for business in 2007 with 40 billion British pounds in deals waiting to close. According to a recent *BBC* report, almost 80 percent of the FTSE 100 is talked about publicly in terms of mergers, acquisitions and buyouts.

Given its prodigious cash flows, no one is concerned about Harrah's ability to service the added debt load. But it will of necessity siphon off cash that would have gone to capital expenditures, and management could face pressure down the road to identify assets and markets that may be deemed less strategic and therefore disposable. Halkyard has said there are no plans to sell any casinos. But the signals from corporate have been mixed. Chairman Gary Loveman has called the buyout a "change in ownership, not a change in direction," but he has also acknowledged that "With high initial debt levels, capital allocation priorities likely will change."

For the rest of the industry, particularly some of the smaller players, this could be a good thing.

"Debt reduction will be one of the underlying themes of this company for the next couple of years," said Gordon, who believes Harrah's ambitions will suffer "modest" delays. But then Loveman has implied as much. Said Gordon, "Until the transaction closes it's difficult to see how they can move forward with their [investment] plans unless these are signed off by the new owners."

By the same token, Harrah's management is too smart not to seize this opportunity to pursue a thoroughgoing reorganization, a process the Caesars acquisition, given its size, had demanded anyway, and no doubt it's been ongoing.

So a lot can happen. And perhaps it already is. Chief Operating Officer Tim Wilmott resigned after Apollo and Texas Pacific entered the picture. He was a 15-year veteran of the company and was considered the No. 3 man behind Loveman and Vice Chairman Charles Atwood. Also gone, as of this writing, are Senior Vice President of Operations Tony Santo and Central Division President Anthony Sanfilippo.

They will not be the only three of Harrah's 85,000 employees to go.

'Really building businesses'

Among workers in Europe the transaction economy is setting off alarms. In a statement released by Swiss-based IUF, which represents millions of food, hotel and agricultural workers, General Secretary Ron Oswald blasted the buyout culture as "a serious threat to workers, their trade unions and their communities."

"When company cash flows become merely a source of plunder for investors seeking inflated, short-term windfall gains we are feeding financial markets rather than creating the kinds of enterprises which can provide decent jobs and future perspectives for a Europe which has been living far too long with unacceptable levels of unemployment."

The alarm has spread to Britain, where the Trade Union Congress issued a report last year titled "Investment Chains" attacking not private equity specifically but the culture of "short-termism," which it claims is threatening jobs and has investment by British companies lagging their counterparts on the continent and in the United States.

Yet for all this, when the dust settles over Harrah's what will be clear is that private equity and the casino industry are perfect for each other. Certainly the deal electrified the public markets. "We believe [it] provides for easier entry into the gaming sector by other private equity firms, which should ultimately lead to higher valuations for the group overall," CIBC analyst David Katz said in a recent note to investors.

As Las Vegas amply shows, the industry's appetite for capital is insatiable. Globalization is an expensive proposition, and the competitive bar continues to rise. In market everywhere, projects that used to run in the tens of millions now cost hundreds of millions to complete, projects formerly in the hundreds of millions now cost billions. The investment cycle is growing in length and complexity as a result, and this is problematic for many investors in the public markets, where opinion tends to run in 13-week spurts. Private equity may have more than its share of fast-buck artists, but they are far from the rule. As owners, fund managers are free to think longer-term and generally they do.

"Gaming is a very long lead-time business, a long growth cycle," Harms explained, "typically five to seven years. With private equity that sits well."

The gambling world certainly is rich with examples of companies that have grown larger, stronger and more profitable under its stewardship. In Europe, private equity has been a preferred source of funding for the industry for years. "Almost every major UK company has been in private-equity hands at one time or another," said Harms, whose firm advised Permira on its 200 million BP investment in casino and bingo operator Gala, which paved the way in 2005 for Gala's 2.18 billion BP merger with bookmaking giant Coral Eurobet, a deal in which Global Leisure Partners was an advisor and co-investor.

Harms holds up Gala Coral as the "poster child, for not only the gaming industry in the UK, but also for the private equity industry in the UK. ... This business was taken from \$200 million in value eight years ago to \$8 billion in value today." And it was accomplished through investment and capital formation, "really building businesses," he said.

At the IAGR conference he offered other examples: "Morgan Stanley has announced that they're building a billion-and-a-half-dollar casino resort in Atlantic City. Colony Capital are rebuilding the Hilton in Las Vegas, they rebuilt Resorts in Atlantic City, reinvesting into the properties that they acquire and creating more profitable properties, creating jobs and therefore creating higher tax bases in the communities in which they're operating, as well as profit for themselves."

Fund managers worldwide raised more than \$300 billion last year, more than enough money to lavish on a "very attractive asset class," as Harms describes gaming, an industry known for stable cash flows, good long-term growth prospects, a business model generally impervious to economic downturns, and one commanding a significant amount of real estate which the public markets are not fully valuing, or so many say. The Harrah's acquisition proves that if the issue is price no casino company is beyond their reach.

Said Gordon, "Any time the largest gaming company in the world goes private it changes the landscape a little bit."

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