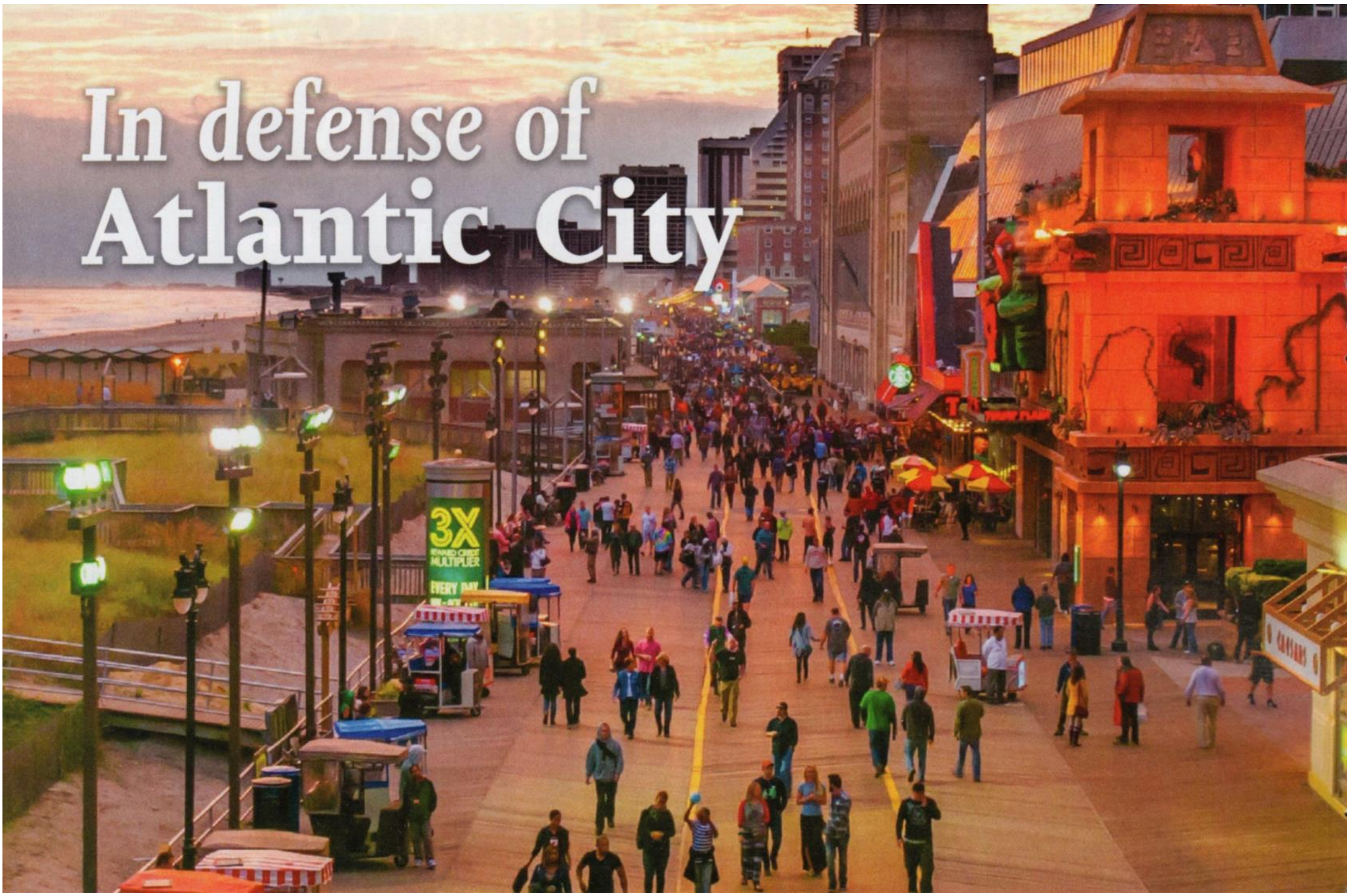
In defense of Atlantic City



A recent ***Wall Street Journal*** headline bemoaned, *"Atlantic City's Blues Play On"* while a **New York Times** headline analyzed *"Atlantic City Grapples With Empty Spaces"* and **CNBC** commentator's wondered if *"glitzy corporate headquarters, condos or timeshares, entertainment-related rentals or even student housing could be among the new uses"* for the shells left behind from a dying casino industry in Atlantic City.

THE ATLANTIC CITY CASINO MARKET IS NOT CRUMBLING…

…not disintegrating, and not failing... and we don't need to turn the casino towers into a student dormitory. **There is absolutely nothing wrong with the Atlantic City gaming market; it is healthy, viable, and sound.** In fact, Atlantic City casinos generate more slot machine revenue than almost every gaming market in America. The Mark-Twain-esque reports of its death, indeed, have been greatly exaggerated.

SLOT *WIN* AMONG HIGHEST IN USA

Consider the average slot machine win-per-unit figures for a dozen casino venues nationwide, reported to state tax authorities and gaming commissions at the end of the first half of this year (2014)[1]:

CASINO MARKET	Win Per Unit Per Day
Las Vegas Downtown	$98
Nevada (statewide)	$122
Colorado	$142
Mississippi	$171
Florida	$173
Las Vegas Strip	$181
Ohio	$186
Louisiana	$217
Missouri	$222
Maryland	$227
New Jersey	$270
Connecticut Tribal)	$280

More surprisingly, the three worst-performing (and closed) properties in Atlantic City out-performed many “healthy” casinos in the rest of the country… on that win-per-unit metric. Compare the win-per-unit-per-day for those three properties to the table above[2]:

ATLANTIC CITY PROPERTY	Win Per Unit Per Day
Trump Plaza	$99
Revel	$152
Showboat	$188

Paradoxically, even the much-maligned and forsaken Atlantic Club was winning around $169 per slot machine per day just before its dying[3].

At the risk of mimicking the idioms of some of my New Jersey colleagues, *“not for nothing, but…”* at least based on win-per-unit-per-day of slot machines, there is absolutely nothing fatal about Atlantic City casinos. *“Not for nothing.”*

WHY THE PANIC?

So what’s the deal; why is everyone running in circles and announcing that the sky is falling? Why are these casinos closing (The Atlantic Club, Revel, Trump Plaza, and Showboat)? Why are thousands of jobs being lost? Why is it that at our industry trade shows I hear our colleagues bemoaning the death of Atlantic City? What is going on and why the panic? *Atlantic City gaming is maturing, changing, and shifting; but that does not make it unhealthy*. At worst, it makes it normal in a business lifecycle. Clearly, there is something up other than slot machine performance. There is hotel occupancy; but the state tax collected for occupied hotel rooms has actually ***increased*** in the past eight years from $684,618 in June of 2006 to 699,248 in June of this year[4].

Okay, here are a few things we know for certain about the A.C. market:

- The days of people standing five and six deep in line to play slots at *Resorts International* in 1979 are decades gone. Casinos in Pennsylvania, Connecticut, Queens NY, Delaware, Maryland, West Virginia, and other I-95 corridor venues have cannibalized the glory days of the Atlantic City casinos and those days will never be recaptured. Atlantic City is not as "in demand" as it was a decade ago or three decades ago. Hence, the reliance on the day-trip bus business is outdated, if not antiquated. Gross gaming revenue in Atlantic City has fallen to less than $3-billion annually; down from $5.2-billion at its peak in 2006[5].

- Even so, the current average win per slot machine unit per day is the highest it has ever been in the 37 year history of Atlantic City, except for 2006[6]:

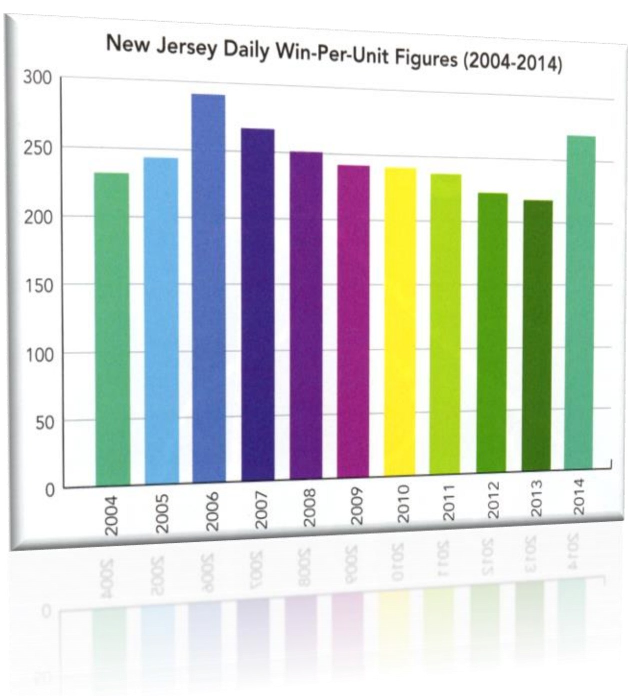
YEAR	WPU
1978	$192
1979	$108
1980	$98
1981	$113
1982	$158
1983	$202
1984	$187
1985	$184

YEAR	WPU
1986	$197
1987	$195
1988	$209
1989	$237
1990	$223
1991	$234
1992	$254

YEAR	WPU
1993	$247
1994	$233
1995	$243
1996	$219
1997	$213
1998	$215
1999	$233

YEAR	WPU
2000	$233
2001	$230
2002	$234
2003	$215
2004	$234
2005	$244
2006	$291

YEAR	WPU
2007	$267
2008	$251
2009	$242
2010	$241
2011	$237
2012	$223
2013	$218
2014	$270



- Despite the seemingly mutually exclusive massive decline in gross revenue and the increase in win-per-unit, it is clear that decreasing market is relative. A market earning that "down to" $3-billion a year is still potentially a lot more interesting than a market earning $329-million a year market[7]. That difference, alone and despite many other positive features, indicates there is something less-than-lethal about Atlantic City.
- We also can't blame the chicken-little-syndrome on taxes; New Jersey's paltry 9.25% effective rate on casino revenue would be a welcomed relief to the oppressive tax rates of Florida (recently "reduced" to "only" 35%), Maryland (67%), and many other "successful" casino venues[8].
- Nor can we blame it on the unions as some have tried to do; while many venues have successfully fought back organized labor, Nevada and most other major locations are still union shops with labor costs competitive with A.C.[9]

New Jersey-based slot machines generated an average win-per-unit of $270 each day [this year], well ahead of the results reported by Nevada, Colorado, Mississippi, Florida, Ohio, Louisiana, Missouri and Maryland.

MANAGEMENT

If it cost $3.1-million to generate $10-million in earnings in one venue and it cost $12-million to generate $10-million in Atlantic City, then there is something clearly wrong. Notwithstanding my well-known penchant for controversy and grandiose exhibitions, I almost *have* to cite the scene from the 1995 Martin Scorsese film, *Casino*:

> *"Listen, if you didn't know you're being scammed, you're too ******* dumb to keep this job. If you did know, you were in on it. Either way, you're out. Get out! Go on. Let's go."*

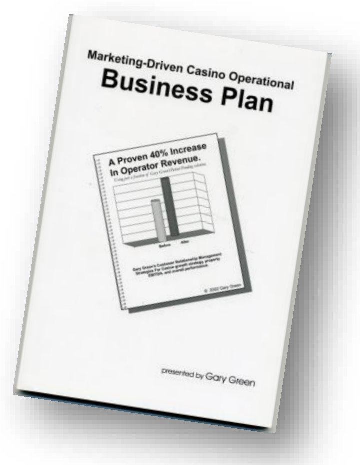
Seriously, the operation of a casino is an extremely formulaic business. Full casino operating costs should range from 31% to 51½% of just slot revenue —*inclusive of labor, tables, F&B, and G&A*— depending on the location, percentage of games that are leased (rather than owned), and marketing/promotional programs. That means if the operator can simply "break even" on table games, food & beverage, entertainment, shopping, etc., the business is still sound just from the slot machines.

This holds true even in the face of the distinct move away from properties' exclusive dependency on gaming revenue (such as Sheldon Adelson's recent pronouncement in *The Economist* magazine that he is not in the gambling racket and that 70% of his revenue came from non-gaming sources).

Based on years of history of independent audits of the financial statements of Native American and commercial casinos, this financial modeling ratio of slot win and operating expenses has been a proven recipe for many successful casino managers and operators. Moreover, the formulaic modeling can be broken down to standard ratios for each operational and administrative department within a casino and even down to line-item expenses for the most common casino expenditures. Even based on slot revenue alone the operating expense formulas include extrapolation to table games, hospitality (hotel), food & beverage, entertainment, and all operational and non-operational business units.

Make no mistake about it, *effective* casino management can scale operational costs (OPEX) to an exclusive ratio of slot-only income and still operate a world-class market-driven property.

Clearly, this has *not* been a widespread management methodology in Atlantic City. (That is exactly what fuels my own business: amazing failings for fundamental casino operational techniques and the divorce of marketing and management.)



During the past four years I have had the opportunity to review the financials of two of the four closed (or closing) Atlantic City casinos, on behalf of potential co-investors in the properties.

I can categorically affirm that neither of those two properties were operating within the standard financial modeling parameters that have been proven time and time again.

More than simple balance sheet management, regardless of "exceptionalism" apologies, and not *even* limited to those two properties (or even the four)… the fact remains that any operator

—any operational management— not performing within these standard parameters is failing.

Modern day Atlantic City has been wrought with failing management. Since the 2012 death of Dennis Gomes, there have been no exceptional operators in Atlantic City. The abysmal management history of *Colony Capital* at Resorts, the Atlantic City Hilton, the Las Vegas Hilton, and Bally's Tunica speaks for itself as a monument to the destruction of once profitable casino properties; and *Avenue Capital Group's* manipulation of resources from The Plaza to prop up the balance sheet valuation of the under-maintained Taj Mahal has clearly handcuffed any operational management from saving either of those properties.

I will spare us my tired soap-box ranting about allowing casinos to be managed by investment bankers, private-equity asset flippers, and business school quants rather than "casino guys". However, given the slot win-per-unit in Atlantic City and the formulaic nature of operations, I will reiterate that failing management in A.C. is either *"too ******* dumb to keep the job" or "in on it".*

INVESTOR EXPECTATIONS

Within a fixed casino revenue projection, for example, of $24-million a month *(the current New Jersey casino average)*, there is a qualitative difference between investing $50-million and $2-billion dollars. All things being equal regarding return on investment, the expectations of the stakeholder for those two investment levels must be fundamentally different. Therein is the Atlantic City investor issue in a nutshell.

Short of management failure or management's hands being tied, the operational profit margin formulas, the debt-to-equity ratios for borrowing, profitability, and capital structure… are all within the venue of investor expectations and requirements for the property. This can manifest as simply as over-leveraging, over-mortgaging, and over-borrowing, or as complexly as a confidence-game-like labyrinth of misrepresented costs, faulty projections, badly-targeted demographics, and neglect of the property to appease investors.

Either track obscures gross operating profit and the simplicity of those management operational formulas…making valuation, at best, tricky and at worst impossible and fostering unrealistic investor expectations.

The two A.C. casinos that I considered purchasing were a monument to the latter. I walked away from both projects because of the atrocious maintence, infrastructure neglect, and dilapidation that the bad mangers and operators had wrought. A third-party engineer, that I had hired to accompany me through one due diligence tour, literally chased me out of the boiler room of one of the casino-hotels warning me that there could be an explosion any minute with pressure valves missing or frozen and obvious years of maintence negligence and mistreatment. *(And that didn't even address the cracked and peeling asbestos insulation hanging from the pipes.)*

Despite the first-page SEC warning of every investment prospectus ever printed cautioning: "*past performance does not guarantee future results"*, Canyon Capital, Chatham Asset Management, Morgan Stanley, and Capital Research & Management were jointly willing to pony up billions to build a casino that stayed open less than 2½ years before announcing it was closing its doors in what the *New York Post* called "the casino that took Wall Street for $2.5 billion". Apparently the past performance of Atlantic City was more compelling that the shrinking market and bad management.

At the same time, while mismanagement resulted in a California group's offer to purchase the Trump Plaza for the cheapest price ever paid for a distressed Atlantic City property (only $20-million for the property that cost $210-million to build almost exactly 30 years earlier)[10], mortgage holder Carl Icahn vetoed the sale in favor of closing the dilapidating casino.[11] (My group had offered $25-million a year earlier and also had been rejected by Icahn, leaving me wondering what hidden agenda I was missing.)

Both examples reflect the general category of investor expectations; or more accurately, *unrealistic* expectations. Let's consider the ill-fated Revel property. At its July 2014 wpu figure of $152 and 2,179 slots, extrapolation to annual slot win projects $119,257,188. With the high end of operating expenses, we would have net revenue of $60,821,165. Forgetting (for the sake of this discussion) taxes, amortization, interest, and depreciation, at that rate it would take 41 years just to recover the investment. *Are you kidding me?* What choice was there other than bankruptcy?

Even that overly simplistic calculation should tell even the most non-Wharton casino operator that this investment is not a good idea. Should the Revel fantasy projections match the market-leading Borgata's $472 win per unit per day, the extrapolated and expense-adjusted revenue would be $257,683,138 and would still take 10 years just *to recover just the investment principal*.

A standard valuation based on a cash-flow multiple was impossible or at best improbable. It is no wonder that the bankruptcy court could not find a viable savior.

Despite grandiose dreams of attracting new market segments or cannibalizing other casinos, any Atlantic City investment must be viewed in context of a highly competitive landscape that has shrunk 45% in eight years. Yet, at the same time, without panicking from that economic reality, such an investment must also be weighed with the reality that even that shrinking market dwarfs most other non-Indian gaming markets in the country.

THE SPECIFIC CLOSINGS

Then, again, what is with the closures? I am arguing that there is no correlation between the four casino failures and the reduction in gross revenue for the market —other than using a pseudo-correlation to justify write-offs, mistakes, or deliberate scams. Let's consider the four failed casinos:

PROPERTY	CLOSURE DETAILS
Atlantic Club	As noted earlier, the casino operational track-record of Colony Capital (the final owners of the property) is well documented in the decay of The Las Vegas Hilton, Resorts International, and the Atlantic Club in A.C. Perhaps in the east coast gaming monopoly heyday of Atlantic City, infrastructure neglect and incompetent management would not have mattered; but in the new competitive Atlantic City, this property was doomed independent of pseudo-correlations.
Trump Plaza	The hedge fund world seems to operate in either of two business models: there is the *Blackstone* model of acquiring and operating companies and increasing brand value for long term investment (Hilton Hotels for example); and there is the *Avenue Capital* model of acquiring distressed assets with bad balance sheets[12] making the bad balance sheets look good by unloading the worst assets and propping up the better assets for an investor exit strategy that does not involve operation of companies. Avenue owns Trump Entertainment Resorts. Under Avenue ownership, operational management of The Plaza had not budgeting control or authority; even the asset of a customer database had been moved to the larger asset (the Taj Mahal) along with maintenance staff (one entire tower was closed with lack of maintence). I strongly insist that once the Trump Marina was sold to Tilman Fertitta, The Taj became the depository for the positive assets of the company and The Plaza became the neglected stepchild destined for failure. It is only bond/mortgage-holder Carl Icahn's veto that forced the closure —a move speculated to be an Icahn move to seize ownership through foreclosure[13]. In short, closing The Plaza is an investor shell game having almost nothing to do with a failing Atlantic City and everything to do with ownership of a piece of real estate and gaming license in the geographic middle of the boardwalk.
Revel	While I could write an entire article (if not book) on the genuinely idiotic opening strategies of Revel Atlantic City, the *New York Post* headline clearly sums up that failure: "How Atlantic City's Revel casino took Wall Street for $2.5 billion.[14]" From the get-go the Revel was a "tale of fool's gold[15]" in setting investor expectations; while it

PROPERTY	CLOSURE DETAILS
	was a great sales job, its failure was predestined and had nothing to do with some sort of global failing of Atlantic City.
Showboat	By Caesars' own explanation, this closing is to reduce machine inventory in the market (and thus drive up the win-per-unit number for the Caesars' footprint in Atlantic City). Though operating profit is drastically down at the property[16], the greater issue may be the private equity war between Appaloosa Management, Canyon Partners and Oaktree Capital against Apollo Management[17] over Caesars' overall investment strategies. By either account, the closing of the Showboat appears to be more of an investment flimflam than a visceral reaction to a non-existence unhealthy state of the gaming market.

Letting "Toto" pull back the curtain and reveal the humbug behind, it is clear to me that the closed casinos are not symbols of a failing gaming market or even an ailing gaming market. They are unrelated examples of bad management and/or investor manipulations thrown against a pseudo-correlation to the natural maturing of the east coast gaming market and an expanding competitive landscape.

Atlantic City is healthy if it is viewed, invested and operated grounded in the reality of the changing market and not in the past or a fantasy of a future.

IS ATLANTIC CITY HEALTHY?

This is a market correction —something my Wall Street colleagues should readily understand. The east coast monopoly bubble has burst and Atlantic City is finally recognizing a disruptive adjustment for an absurd overvaluation. After the correction, Atlantic City is more than a viable market; it's a deal. Yes, in a market correction someone takes a hit. Unlike the consumer real estate collapse where the little guys took the hit, it Atlantic City it's some of the corporate "thronemasters" that took the hit.

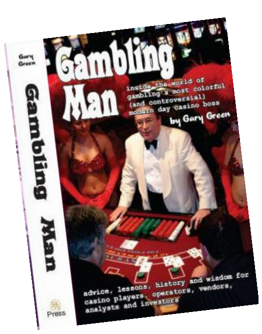
Amidst it all, Atlantic City absolutely is healthy…

- *IF* the debt service and investment costs are not unrealistically high;
- *IF* investor expectations are not set unrealistically;
- *IF* the casino is operated and managed within specific standard parameters;
- *IF* the purchase of the property allows asset value to at least double liabilities;
- *IF* the casino(s) is/are treated as *gaming* properties and not as chessboard pawns for unloading;
- …and *IF* there is an adoption of a non-cannibalistic marketing methodologies (not a "plan") that can empirically provide verifiable revenue projections.

Many of the doom-forecasters acknowledge that my analysis of the numbers is correct, but they still see the *Apocalypse of Baruch* in the mystic vapors of free slot play, management's inability (or refusal) to refocus from the 1980s day-trip demographic of players, and a host of other seemingly irrevocable and somehow objective death knells for Atlantic City. Again, my thesis here is that operational management, marketing management, and strategic management it Atlantic City has been an abysmal failure. Coupling that wholesale incompetence with almost-comical investor expectations (or at least pitches to investors), there indeed is a pending finality for gaming in Atlantic City.

Correcting those two factors, I have incredible optimism —*based on hands on operational experience and detailed due diligence of existing Atlantic City properties*— for the potential R.O.I. of an Atlantic City casino purchase.

In short, Atlantic City is healthy if it is viewed, invested, and operated grounded in the reality of the changing market and not in the past nor a fantasy of a future. Atlantic City never again will hold the east coast monopoly; but within the changed parameters it can outperform most other gaming jurisdictions in the country. This is a great time to invest in Atlantic City. Casinos can be grabbed at fire-sale prices. Atlantic City casinos are earning more than most other markets in the country. If you can get in for the same investment as you could get into another market, Atlantic City is healthy, viable, sound… and smart.



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[1] Source: University of Nevada Las Vegas Center for Gaming Research; State of New Jersey Division of Gaming Enforcement; Mississippi Gaming Commission; Missouri Gaming Commission; Louisiana Gaming Control Board; and Nevada State Gaming Control Board Gaming Commission.

[2] New Jersey Division of Gaming Enforcement; and University of Nevada Las Vegas Center for Gaming Research.

[3] Spectrumetrix Atlantic City Gross Gaming Revenue Analysis

[4] State of New Jersey Department of Treasury Division of Taxation, Hotel/Motel State Occupancy Fee And Municipal Occupancy Tax

[5] Union Gaming Research, June 19, 2014

[6] Nevada Las Vegas Center for Gaming Research

[7] New Jersey gaming revenues versus Florida gaming revenue, source: University of Nevada Las Vegas.

[8] National Conference of State Legislatures January 2014 Casino Tax and Expenditures

[9] Culinary Workers Union, Nevada Local 226; and UNITE HERE representational reports for California, Florida, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, New York, Ohio, Pennsylvania, and Rhode Island, as well as in Ontario and British Columbia.

[10] Casino Connection AC, August 2014

[11] The Washington Post, July 14 2014

[12] https://www.avenuecapital.com/strategies.aspx?strategy=U.S.%20Strategy

[13] Global Gaming Business Magazine, July 14, 2014

[14] Op cit

[15] ibid

[16] Global Gaming Business op cit

[17] Barron's April 12 2014