Legislative DYNAMITE

State failures the exception to the rule

By Steven M. Gallaway

As state budget crises continue to sweep across the nation due to the effects of the Great Recession, more and more states are making foolhardy decisions in an attempt to plug part of a budget deficit that may benefit them in the short term but will ultimately hurt them in the long run.

Many investors in the gaming world have historically been gun-shy of investing in many international destinations due to legislative risk, viewing the United States as a stable jurisdiction in which the future is predictable. However, events of recent years have shown this premise of legislative stability in the United States as false.

New Jersey, feeling the pressure to expand gaming outside of Atlantic City to help reduce its deficit, has an opportunity to do it the right way that will benefit all stakeholders. Hopefully, they follow sage advice and set the example to how to responsibly expand gaming while simultaneously benefiting companies that have invested billions in their state.

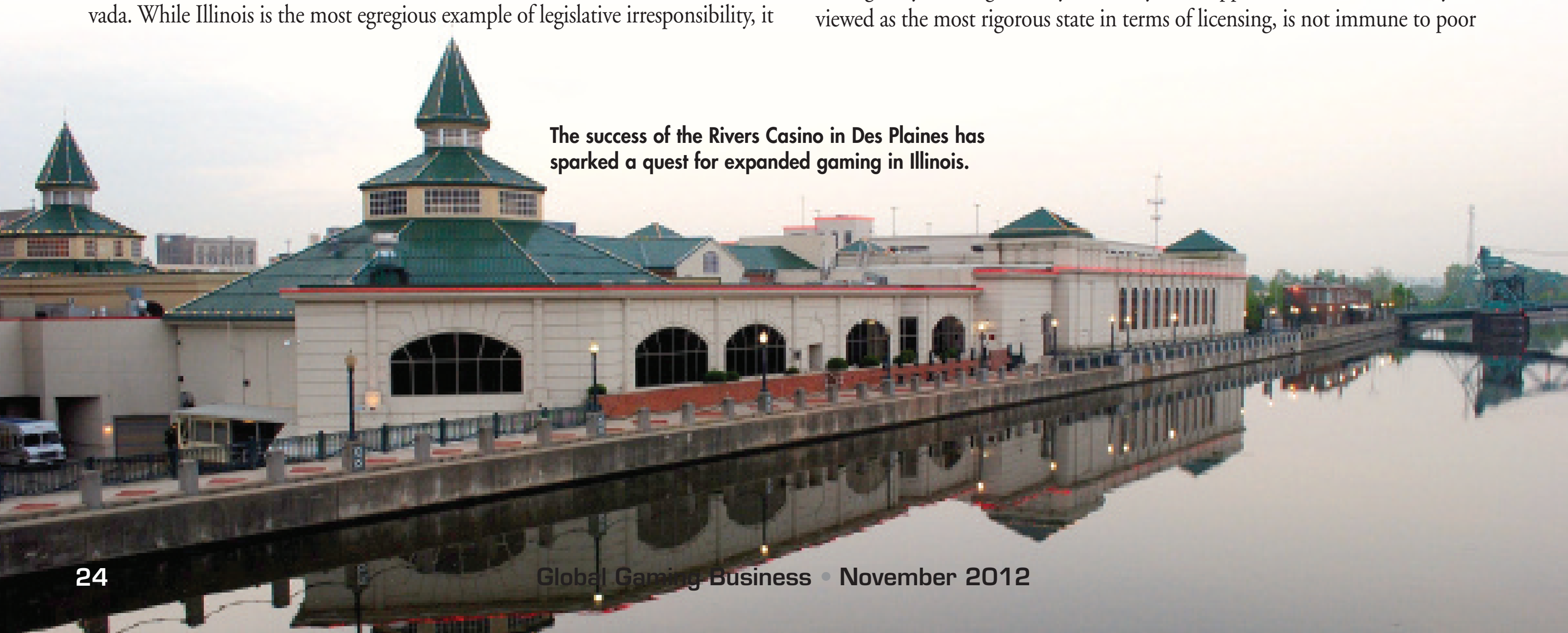
The Violators

Illinois is arguably at the forefront of legislative irresponsibility, having introduced legislation each year over the past decade that threatens its existing operators—from the 2009 legislation permitting video gaming in bars (which analysts estimate will add between 35,000 and 75,000 devices across the state) to slot machine gaming at racetracks, to the possible authorization of five new casinos throughout the state, to a complete expansion that would turn Illinois into Nevada. While Illinois is the most egregious example of legislative irresponsibility, it is far from alone.

The Maryland legislature recently voted to allow a sixth casino in the state, in Prince George's County, just south of Washington, D.C., pending the approval of voters in early November. This legislative action took place just months after the Cordish Companies opened its Maryland Live! casino, investing $500 million, going after the exact same market. Had Cordish executives known that a Prince George's casino was even on the radar screen when they applied for their license, their building plan would have looked significantly different, as they will probably be unable to receive a satisfactory return on their investment with a competitor now contemplated that could capture up to 40 percent of their market.

The list of offending states goes on and on. Florida is continually in limbo, with racinos paying an extraordinary tax rate and discussions continuing in Tallahassee to authorize large-scale casinos to be built in Miami and Broward at much lower tax rates (the last round was not going to give a tax break to the racinos, which would have crushed the racinos and ironically decreased the net revenues to the state). The most recent round of legislation died, but one can be sure that it will be revived next session. (Genting, which purchased $236 million worth of beachfront real estate in Miami with the intent of building Resorts World Miami, does not have a history of going away quietly.)

Threats of increasing the gaming tax rate in Nevada have become a never-ending story, although luckily that has yet to happen. Missouri, historically viewed as the most rigorous state in terms of licensing, is not immune to poor



The success of the Rivers Casino in Des Plaines has sparked a quest for expanded gaming in Illinois.

The unfinished Xanadu project at the Meadowlands

The owner of the Meadowlands would like to increase his cash flow and the value of his property and the legislators just want to help fill a budget deficit and get re-elected. Let's all just be friends and find out what makes sense.

legislative decisions either. Shortly after Pinnacle Entertainment invested more than $1 billion in the state between the construction of Lumiere Place and the River City Casino, the Missouri Gaming Commission decided to yank its license for the President, a down-market casino which Pinnacle had bought to help predict its competitive future.

Mind you, Pinnacle officials had not planned on keeping the boat as-is; rather, they had offered to upgrade the vessel and were actively looking for alternate locations in the state to move that license and build a new facility. It was this situation that led Dan Lee to (understandably) lose his cool with the Missouri Gaming Commission, which was the proverbial "straw that broke the camel's back" that resulted in Lee losing his job as CEO of Pinnacle.

This is just a partial list, with many other offenders spread throughout our great country.

Why States Should Care

This short-sightedness of legislators looking to plug a budget deficit or allowing lobbying dollars from potential winners of new gaming legislation to influence their decisions completely ignores the impact those decisions will have on existing businesses—i.e., the casinos and supporting businesses that have collectively invested billions of dollars in their facilities. Casinos are traditionally excellent members of their host community. Legislatively, casinos are usually required to pay a percentage of their gaming revenue to local authorities that equates to a greater percentage of profit than any other industry would have to pay.

Not required legislatively but to be good corporate citizens, casinos support local events, host community meetings without charge, donate and host fundraisers for local charities, are active members of the local chambers of commerce, sponsor local sports teams (professional and community leagues alike), provide above-average pay for jobs, train and provide jobs for unskilled labor and provide excellent health benefits.

What legislators risk with their irresponsible actions is twofold. First and foremost, jobs will be lost, and revenue to local host communities will decline. Second, all casinos in the state will be hesitant to expand their operations in fear that another change in the legislative landscape will occur and have a similar impact on their operation as happened to their competitor. Instead of enabling legislation that hurts existing operators and businesses, why not work in conjunction with the operators and find a mutually beneficial change to legislation that will bring more money to the state, create more jobs and allow existing operators to benefit in the macro as well?

Xanadu at the Meadowlands

To date, New Jersey has not fallen prey to the allure of reckless gaming expansion as have other states. New Jersey casinos have been protected by local legislators who have argued successfully not to allow an expansion of gaming in other parts of the state. However, we all see the writing on the wall. New Jersey casinos have received three gigantic blows: the introduction of casinos in Pennsylvania, the opening of the racinos at Yonkers and Aqueduct near New York City, and finally, the effects of the Great Recession.

This resulted in years of declining revenues, resulting in bankruptcies, casinos not having money to reinvest in yearly cap-ex and even some having difficulty meeting operating expenses. Not only have the casinos and surrounding businesses suffered, but the replenishment of the state coffers from gaming taxes has slowed dramatically. With gaming revenue declining from a high of $5.2 billion in 2006 to $3.3 billion in 2011, and with 2012 not showing any improvement, the state continues to receive smaller and smaller checks from down south.

While most experts believe the bottom has been reached in Atlantic City, and that soon small trickles in growth will begin, pressure increases to authorize slot machines at the Meadowlands, a sports and entertainment complex only minutes from Manhattan. On one side you have the gaming industry appropriately lobbying to prevent this from happening. On the other side you have representatives from the Meadowlands and legislators from the northern part of New Jersey, whose constituents are not impacted by the economics of southern New Jersey, promoting the financial benefits that could be realized by a casino at the Meadowlands and increased tax revenue to the state.

An opportunity exists here for all groups to come together and introduce legislation that benefits all parties. Most of the casinos in Atlantic City are owned by large public or private companies that have access to capital for good projects. The owner of the Meadowlands would like to increase his cash flow and the value of his property and the legislators just want to help fill a budget deficit and get re-elected.

Let's all just be friends and find out what makes sense. A few years ago a well-seasoned and respected industry executive with extensive experience in Atlantic City discussed in broad terms his solution to Atlantic City; we'll call this the JP Plan.

The Details

Numerous detailed studies in Atlantic City, examining market research—studying casinos' databases, and simply using common sense—have concluded that a significant amount of Atlantic City's casino revenue comes from the northern half of the state and the New York metropolitan area. This finding is further supported by the huge declines in gaming revenue experienced at Atlantic City casinos as the Sands Casino Resort in Bethlehem, Pennsylvania; the Empire Casino at Yonkers Raceway and Resorts World Casino New York City in Jamaica, New York (Aqueduct) continue to ramp up and enhance their operations.

The reason for these casinos' successes is not because they built a better mousetrap; rather, they built a mousetrap closer to the mice. Regional gaming is about convenience, and Atlantic City, although flush with hotel rooms and other amenities, is, at the end of the day, a regional gaming destination.

The Meadowlands is located just outside of New York City in East Rutherford, New Jersey. The complex has extensive acreage, is familiar to all residents in the tri-state area due to its sports complexes, and is located immediately off of I-95 with close access to I-80, I-78, I-280 and almost every other major artery

Atlantic City would be negatively impacted by in-state competition.

that feeds northern New Jersey. A slots facility here would produce incredible levels of gaming revenue, but the question remains how to do it responsibly.

Xanadu was a non-gaming entertainment complex at the Meadowlands that included retail, dining and entertainment options. Construction was halted when the economy collapsed, and it has yet to resume.

The JP Plan calls for a casino megaplex to be constructed at Xanadu. Xanadu would consist of up to 12 casinos, a total of 8,000 to 10,000 slots, a wide variety of restaurants and only limited retail. Despite the large number of slot machines, hotels on site would not be part of the development. Each existing casino in Atlantic City would be allocated its share of the slot licenses based on their share of casino hotel rooms within Atlantic City.

The reason hotel rooms are used instead of slot machines is simple: a hotel room requires more capital expenditure than does a slot machine, and casinos have already invested billions in their hotel rooms. As such, the goal is to recognize the capital expensed by Atlantic City operators and divide the total number of authorized slots based on their share of hotel rooms.

For those casino companies that operate more than one casino in Atlantic City, such as Caesars Entertainment, they may choose to combine their slots into one larger facility and act as an anchor to the development, similar to a department store in a mall. Should an Atlantic City operator choose not to utilize some or all of their licenses, they would retain the right to sell or lease those rights to another Atlantic City operator at whatever rate the market would bear.

With regards to food and beverage outlets, the market would define what is ultimately constructed. The owner of the Xanadu development, likely the owner of the Meadowlands, would be required to provide a minimum of amount of square footage dedicated to this space.

While each casino would be allowed to build its own casino and basic bars and lounges, space for restaurants or combination restaurants/bars would be leased out at fair market rates, with the casino operators having first right of refusal. Some operators may choose to operate at least one venue adjacent to their casino space on their own, while others may be content with their customers using outlets leased to outside operators. Considering the large volume of throughput expected at Xanadu, it is likely that well-recognized third-party operators such as Cheesecake Factory and Starbucks would be interested in leasing space.

Why no hotel rooms? The goal of Xanadu is to increase tax revenue to the state, increase cash flow to Atlantic City casino owners and help reinvigorate visitation to Atlantic City. Xanadu's proximity to the core population of the New York metropolitan area will allow gamers to get their convenience-based gaming visits while earning points in each respective casino operator's rewards program. Let them save their points and redeem them for fun-filled times in Atlantic City. Hotel rooms at Xanadu would discourage that behavior.

For those patrons who must spend the night, it's likely that limited-service hotels will be popping up around the site. In addition, those hotels already in the area will benefit, and as such, support the Xanadu development.

The Results

With the proper development, the revenues generated at Xanadu could expect to be north of the $1 billion mark. With Xanadu 1) consisting of the strongest brands in the region that have an existing database of nearly every gamer in northern New Jersey and the New York metropolitan area, 2) located in the heart of the largest population center in the United States with excellent access to those populations and 3) with a well-designed gaming complex assembled by some of the best in the industry (yes, the operators found in Atlantic City), the upside for New Jersey is fantastic.

However, if this were to be done by only one brand and one without the databases possessed by the casinos in Atlantic City, the revenue potential would not come close to that of Xanadu, and we would end up with a slot parlor that simply sucks revenue out of Atlantic City.

Would Atlantic City feel an impact on its gaming revenue from Xanadu? Absolutely. But with estimates of the initial revenue generated at Xanadu, only 25 percent to 33 percent would come from Atlantic City, about 25 percent to 33 percent would be new market growth and the remainder would come from competitors in surrounding states. However, long term, this would benefit Atlantic City due to the synergies of having a satellite casino in the hub of your population base to feed the mother ship in Atlantic City. Long-term, this would be good for Atlantic City. Short- and long-term, this would be good for Atlantic City's operators.

There are many more questions to be answered that surround this plan. These include the fair tax rate (more than Atlantic City today but much less than the prohibitive rates of Pennsylvania and New York), what percent of revenue goes to the owner of Meadowlands for providing the land and supporting this development, and compiling more specifics of how much land will be allocated to the development, and who pays for it. But with the basics of the plan benefiting the state of New Jersey, Atlantic City casinos and the owner of the Meadowlands, this is a plan that can work and be a model for other jurisdictions of how to work with businesses in your own state and reach common goals.

Oh, why Xanadu? At the end of the day, gaming is a form of entertainment. We provide people with a place to relax, get away and have some fun. Xanadu will simply be that stately pleasure-dome.