

THE MOROWITZ QUARTERLY

PREMIER ISSUE

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THE MOROWITZ QUARTERLY

STRATEGY AND FINANCE FOR THE GAMING INDUSTRY

Cory H. Morowitz

Welcome to the first issue of The Morowitz Quarterly. Our mission is to bring you insightful research and knowledge about the gaming industry. When gaming supply was scarce, operators could add assets and expect reasonable and sometimes outsized returns on invested capital. As gaming proliferates, strategy is becoming increasingly important. How firms position their assets within competitive markets and the alignment of their assets and activities to the marketplace will determine whether they will create sustainable businesses and superior returns for their capital providers. In this and coming issues, we will analyze the strategic choices available to gaming firms and provide insight into winning strategies in competitive markets.

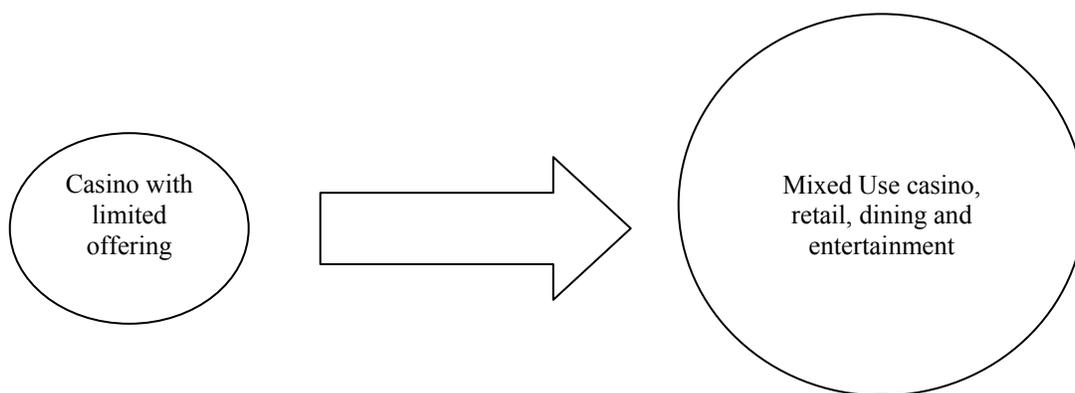
As gaming, entertainment and retail converge, operators will be faced with complex decisions with respect to optimizing the portfolio of assets within a given gaming environment. Determining whether and how much of a retail and entertainment offering should be added to a property or master planning a site for maximum return and competitive advantage requires sophisticated quantitative and qualitative analysis. We will be on the forefront of researching and providing the tools that operators will need to make these decisions.

In our first issue, we delve into the defensive strategies employed by Atlantic City operators to meet the challenge of the Borgata, we look at the real estate opportunities embedded in gaming firm strategies and the impact that these opportunities have on gaming firm value as well as a process for optimizing these real estate investments and we discuss the convergence of gaming and entertainment and the inevitable march of the convenience gaming operation toward entertainment superstore. We also provide insights from an industry food and beverage insider on the future direction of dining options in Atlantic City. Finally, we crunch some numbers to help operators understand the relationship between supply and demand, the impact of gaming strategy on returns, and the optimal size of a gaming firm.

In future issues we will analyze the winning strategies in locals markets, the likely impacts of Pennsylvania gaming on other east coast markets, hotel development in capacity constrained markets and much more. Enjoy this issue and let us know if there any topics you would like explored in the future. 

THE EVOLUTION FROM CONVENIENCE GAMING OPERATION TO ENTERTAINMENT SUPERSTORE

IS IT INEVITABLE?



Everyone knows the history of modern Las Vegas but few focus on its earliest days. The early days of gaming in Las Vegas were not unlike those of other jurisdictions. Smaller gaming centric casinos, serving a mostly locals based customer (Hoover Dam and defense workers). Later, such legendary (and infamous) figures as Bugsy Siegel would create gaming and entertainment resorts, geared toward drawing patrons from far away locales. In the late 1980's, Steve Wynn developed the Mirage, forever changing the gaming landscape. The Mirage ushered in a wave of investment that continues to this day. The resorts built by Mr. Siegel were gaming centric, that is, they derived the lions share of their revenues and profits from gaming operations. The Mirage made it possible for operators to realize that they could derive greater than 50% of their revenues from non-gaming offerings such as hotels, dining, entertainment and retail. This progress from gaming

centric product to entertainment superstore occurred over a period of 50 years in Las Vegas.

Atlantic City was the second major jurisdiction (apart from Nevada) to enact casino style gaming legislation during the modern era. The New Jersey gaming act required casino operators to open with attached hotels of 500 rooms or more. The legislators were fearful that the casino operators would consider rooms a detriment to their gaming operations, and rightly so, the initial thinking being that rooms represented a constraint toward maximizing profitability. From their beginnings in the late 1970's through the opening of the Borgata in 2003, Atlantic City's casinos provided a purely gaming centric experience. The typical casino in Atlantic City derived 80% to 85% of its revenues from gaming operations with a significant portion of the additional

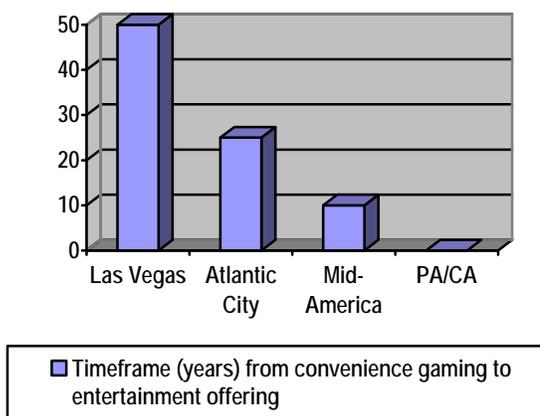
revenues competed to gaming customers in the form of promotional allowances. The Borgata opened in 2003 with a different strategy. While not as grand as the Las Vegas superstores, the Borgata was a category killer with non-gaming revenues, including those from cash paying customers, significantly outpacing those of the competition. The Borgata asked and answered a question...can the Las Vegas model be replicated in Atlantic City? The answer was a resounding yes. While Atlantic City has a long way to go in terms of its non-gaming infrastructure (rooms, dining, retail, convention facilities) and may never approach Las Vegas as a destination resort, the City has proven there is a market for entertainment and non-gaming centric offerings and the market will pay up for quality. What took 50 years for Las Vegas to realize, took only 25 years in Atlantic City.

The recession of the early 1990s caused many cash strapped state governments to look for new revenue sources. Gaming became the panacea and answer to their prayers. During the decades of the 1990s and 2000s, several states enacted some form of casino gaming including land based (New Orleans, Michigan, Colorado, South Dakota), riverboat gaming (Iowa, Illinois, Mississippi, Louisiana, Missouri, Indiana) and racinos (Delaware, Iowa, New Mexico, Oklahoma, Louisiana, West Virginia, Maine, New York and Pennsylvania). In addition, several states entered into compacts with Native American tribes, authorizing casino style gaming. Most of the operations built in the early 1990s were similar in nature; convenience oriented gaming establishments offering a gaming centric product geared toward serving a mostly locals (0 to 100 miles) customer base. As competition increased in each market, or as revenues and profits peaked, operators started looking for ways to appeal to more distant markets, and increase cash flows. This has resulted in many of the riverboat operators adding retail, dining and entertainment offerings, Detroit operators announcing permanent casino investments and several Native American properties (such as Foxwoods and Mohegan Sun) adding significant

non-gaming amenities. The time frame for this shift has been anywhere from five to ten years.

Today, in new and emerging jurisdictions such as Pennsylvania and California, operators are opening under a different paradigm. Several of the proposed Pennsylvania operations have a significant non-gaming component. Las Vegas Sands Inc., operators of the Venetian in Las Vegas, has proposed a mixed use development near Bethlehem, Pennsylvania with over \$800 million of investment. The owners of Pocono Manor have announced a greater than \$1 billion investment with significant retail, dining and entertainment facilities. Several proposed Philadelphia casinos call for significant non-gaming offerings. In Southern California, several tribal operations including the Barona Valley Ranch and the Pechanga Resort, opened with mixed use facilities and significant non-gaming offerings. In both Pennsylvania and California, the timeframe from convenience gaming to entertainment destination is almost zero.

Like any other industry where innovation drives success, it appears that some learning is occurring in the gaming industry.



Casino operators are faced with some basic decisions. Do they remain gaming centric, with operations geared toward supporting a gaming product, or do they continue down the existing

learning curve, and transform their operations into an entertainment superstore. In order to answer this question, we have created a set of guidelines that can help operators assess the future direction of their property offering.

Increased competitiveness requires clear strategic positioning

The need for a clear and concise strategic position is dependent on the intensity of competition in a given marketplace. Firms operating in non-competitive or capacity constrained markets provide gaming centric offerings and drive cash flow and returns by continually adding gaming capacity. As competition increases, the ability to extract incremental returns from gaming investment diminishes. At this point, successful firms create a competitive position either through a mass market offering (Venetian, Bellagio, Mandalay Bay, Borgata, etc.) or through a niche orientation (Hard Rock, Palms, Harrahs, Showboat). Mass market operators attempt to maximize both gaming and non-gaming revenues through large physical plants (rooms, dining, retail, etc) while niche operators offer assets that either support the gaming offering (Harrahs) or non-gaming assets that appeal to the specific customer niche. In Atlantic City, Harrahs realized too late that their targeted customer responded to the superior product offered by the Borgata, and lost market share. As a result, Harrahs has announced a major retail, dining and entertainment initiative. The lesson – increased competition is the catalyst of the evolution to entertainment superstore.

In capacity constrained markets, incremental investment may not move gaming revenue sufficiently

In some markets, such as Arizona or California, capacity is limited by state compact or regulation. In many of these markets, gaming revenues are constrained, not by the lack of non-gaming amenities, but by the inability to yield additional gaming revenues from a limited supply. Typically, slot machines or tables are full to capacity during

peak demand periods and aside from pricing strategies (betting limits, etc), gaming revenue is maximized. In our experience, operators in these markets consider investing excess cash flows into non-gaming amenities such as hotel towers based on the convention that adding rooms increases gaming revenue. We caution operators in these markets that adding non-gaming capacity may have a limited impact on gaming revenues. Aside from petitioning for additional gaming capacity, these operators would be better served investing in assets that result in incremental non-gaming cash flow and superior returns on investment. This might include a hotel and entertainment offering, but the operator must be clear that the new offering is intended to serve new markets, or wrest incremental spending from current customers.

Leisure alternatives of target population affect strategic positioning

Even in non-competitive markets, there might be a compelling case for the addition of non-gaming assets. Station Casinos is a good example. Station operates full service casinos, geared to a locals market, at locations surrounding the city of Las Vegas. Their most recent offering, Green Valley Ranch, operates in a relatively non-competitive environment, servicing the locals of Henderson Nevada. The property was developed as a casino with an attached retail, dining and entertainment offering called “The District.” The property has become a favorite hangout for locals, not just as a gaming product, but as a dining and socializing product as well. The area surrounding the property is relatively undeveloped, and although entertainment and dining options abound in the Las Vegas valley, there are none that are so convenient for the residents of Henderson.

Developers of casinos in other non-competitive markets should take note. The usual gaming centric offering is designed to appeal to a very specific customer set i.e. gamblers. In most markets, this limits visitation to the property. In markets where entertainment options are limited, developing a

retail, dining and entertainment offering can lead to incremental visitation, gaming revenues and cash flows, sometimes with a superior return on investment. Examples include the offerings provided by the two casinos in Connecticut. Each of these casinos draws in excess of 10 million patrons annually, partly due to their enhanced product.

Politics matter

In markets with unstable or unfriendly regulatory environments, operators may be constrained in terms of the offering they can provide. In New Orleans, Harrahs was precluded from adding a hotel to their project, due to regulatory limits and concerns about the impact on the local hotel industry. In other markets, the constraints might not be so overt. We are aware of one operator that considered a major dining option, but declined to make the investment because of concerns that an unfriendly legislature would frown upon the impact it would have on other restaurants nearby. The lesson? Understand the legislative environment before making major non-gaming investments.

Tax rates impact capital investment, but recent events may suggest otherwise

Conventional wisdom has it that higher taxes crowd out investment. Las Vegas and Atlantic City are usually cited as evidence of the phenomenon. Nevada and New Jersey each have gaming tax rates at 8% or lower and the level of capital investment in these two jurisdictions is greater than any other market. The wisdom is backed up by simple math. Higher gaming tax rates reduce the cash flows from the investment and lead to lower rates of return on invested capital. However, recent evidence suggests that operators are challenging this conventional wisdom, at least on paper. Major proposed developments in Pennsylvania, where tax rates are in excess of 50%, call for investments ranging from \$800 million to over \$1 billion. The thinking behind these investments, is that the development will stand on its own, apart from the gaming product. These mixed use, retail, dining and entertainment offerings

are designed to draw patronage to the property resulting in both incremental cash receipts and gaming revenues. Time will tell if these investments are successful, but the message is clear, operators now believe that the entertainment super store concept is viable in a high tax environment. The implication is that the inevitable march from gaming centric product to entertainment destination cannot be stopped.

Expect declining returns on invested capital as you migrate to a more full service offering

There are significant differences between convenience and destination operators. Typically, convenience operations have low investment (less than \$200 million), lower revenues and higher returns on investment. Examples include racino operations, some riverboats and many tribal casinos. Returns can run from 20% to over 100%. Destination operations are often characterized by much higher investment and revenues, but lower returns. Examples include the Venetian, Mohegan Sun and the Borgata where investments are greater than \$1 billion and returns are typically in the 20% to 25% range.

Operators must be honest with themselves. If return on investment is the criteria by which they measure success, they might be disappointed as they migrate to a more full service offering. Some Tribal casino operations, as well as some early riverboat operations, realize returns in excess of 100%. Adding additional gaming capacity as well as non-gaming amenities usually results in erosion of these returns. Not that the new investment has negative returns. Quite the contrary, the new investment usually grows cash flow, but the incremental returns are usually much lower than the outsized returns realized in the early stages of the enterprise. For a tribal operation, this is not an issue. As long as the new investment has a greater return than can be realized by investing elsewhere, the declining returns are not an issue. The tribe realizes greater cash flows, services its new debt and everyone is better

off. However, Wall Street often punishes public companies that realize lower incremental returns. Investors expect historical returns and price them into the valuations that they place on these companies. When these returns decline, stock prices usually suffer.

Understanding and managing investor expectations is the key to maintaining valuations or at least shareholder happiness as the property migrates from convenience to destination operation.

Optimize real estate assets wherever possible

Gaming operators should focus on acquiring as much real estate to complement their facility as possible. A gaming facility generating \$50 million in annual revenues with a \$66 per trip loss is attracting over 750,000 annual visitors to its facility. Any facility that generates that level of patronage is an attractive site for additional development, be it gaming or other investment. In some jurisdictions, per trip non-gaming spend per visitor could be \$5 to \$8 per trip. The probability of increasing spend per visitor through additional real estate development is very high. Providing patrons a reason to stay at the facility for longer periods of time can increase gaming revenue by increasing time on device. Stronger non-gaming attractions can induce additional spend per visitor for such items as meals, beverages, retail, entertainment and even real estate purchases such as timeshares and condominiums. Patrons can also utilize marketing credits at adjacent facilities, enhancing the value equation provided by the operator.

These development options increase the value of the gaming facility and also provide opportunities for balance sheet re-engineering through third party asset sales or development. In terms of the ability to create long term sustainable value...the more real estate, the better.

Understand the relationship between gaming and non-gaming assets

Hopefully we have convinced you that there is an inevitable convergence of convenience and destination oriented gaming. Once operators settle on this inevitability, the key to optimizing cash flows and long-term value, is understanding the relationship between the gaming and non-gaming assets. Operators with fully integrated gaming and non-gaming products generate higher returns than those without. A case in point is Mohegan Sun in Connecticut. Their master planned gaming and entertainment product has yielded total returns in excess of 20% and EBITDA of over \$350 million in a relatively high tax (effective rate over 17%) environment. Similarly, the Borgata and Showboat casinos in Atlantic City, which vie for different markets, each have built well integrated products, yielding over 20% returns on investment. The Green Valley Ranch, outside of Las Vegas, a master planned, fully integrated development, with third party, off balance sheet investment, has yielded similar returns.

Examples of sub-optimally integrated investments include the Tropicana in Atlantic City. While the Quarter, their retail, dining and entertainment project has been a resounding success, overall property return on investment is less than 11%. We attribute this to the non-integrated nature of the property, which similar to other Atlantic City properties, was not master planned and grew opportunistically over time.

For new property developers, the importance of master planning cannot be overstated. All things being equal, a well designed integrated offering with a strategy that fits the offering will yield superior results compared to a non-integrated facility. For operators saddled with older, misaligned offerings, the wrecking ball might not be a bad alternative. 

REAL ESTATE IN PLAY

MAINTAINING LOFTY VALUATIONS

The current thinking in gaming development is that the casino is just part of a larger real estate play. Last year, MGM Mirage announced their Turnberry development, a project that will transform the famous Strip into a cosmopolitan Mecca. Boyd Gaming announced a similar development for their Stardust site. The MGM and Boyd projects will add significant non-gaming assets including resort high rise development. MGM and Boyd have effectively determined that the highest and best use of their respective Las Vegas real estate is as mixed use, master planned development, where gaming is only one piece of the value equation.

Harrahs recently announced the purchase of the Imperial Palace in Las Vegas for \$370 million, well above the value of its existing operations. The Tropicana in Las Vegas sits on 34 acres of prime real estate that based on current prices could be worth over \$680 million yet currently only generates EBITDA of approximately \$40 million. Aztar has even crafted a master plan that would split the property into two 17 acre sites, one for current and one for future development.

In Atlantic City, several casinos have announced or are considering projects that maximize the use of fallow real estate surrounding their properties. Borgata is presently engaged in a two phase development, adding rooms and significant non-gaming assets, while Colony recently acquired the Atlantic City Hilton, including over 12 undeveloped,

mostly beachfront acres for over ten times trailing EBITDA. Colony has indicated their intentions to add rooms and possibly timeshare development at the site. The Tropicana in Atlantic City has expanded beyond their retail experiment (The Quarter) and announced a luxury residential development.

So, what is going on here? Is gaming now all about real estate development? A look at some of the valuations of public companies suggests it very much is. Adjusting for such growth stocks as Las Vegas Sands and WYNN, our index of gaming stocks indicates valuation multiples of over eleven times EBITDA, a greater than 16% increase in multiples from the prior year. Are gaming firm valuations riding the tide of increased real estate values or are fundamentals driving these valuations? One can argue that gaming firms have been traditionally undervalued and the run-up is simply a correction to a previously under-priced asset class. However, this could be a dangerous approach if the increased valuations are relative to unexploited growth options that attach to the real estate.

A look back in time suggests that successfully exploiting the values inherent in real estate development and taking advantage of the opportunities before these so called growth options expire is the key to maintaining these lofty valuations.

Approximately twenty years ago, Resorts International commanded outsized valuations, largely based on their vast portfolio of undeveloped real estate in Atlantic City. In 1986, Resorts' enterprise value was approximately \$1.25 billion and approximately \$250 million of that value was attributable to its undeveloped land holdings. Resorts International no longer exists as a public company, having gone through bankruptcy, numerous takeovers, and ultimately the sale of its assets to Colony Capital for \$140 million. The lesson? Resorts failed to execute on the growth options inherent in their real estate portfolio. They never added on to their existing casino (until recently), failed to develop new ones and then the inevitable happened. The real estate bubble in Atlantic City burst. Their once prized possessions became an albatross around their neck. It took over a decade for the Borgata to develop their new casino and start a new wave of development. Suddenly, Atlantic City real estate is hot again.

So, where do we go from here?

First, gaming operators must understand the fundamentals of their valuations. Determining the present value of existing operations is a good start. This would allow gaming firms to determine the option value embedded in their real estate portfolios. Take the fictional example of a mature gaming property in Las Vegas generating \$20 million of EBITDA. The property sits on 20 acres of prime strip property, giving it a value of \$400 million. The present value of the cash flows associated with the existing operation might be generously pegged at \$160 million. This would suggest that the property has approximately \$240 million of option value.

The next step would be to inventory the various options associated with the real estate. The options could include the right to sell all or part of the property, the option to add non-gaming assets such as retail, time share or condominium development, the right to improve and add to existing operations,

or the right to demolish the existing casino and build a newer property.

Once this inventory is completed, the characteristics of each of these options would be mapped and compared. These characteristics include the likely time before each option must be acted upon, the cash flows associated with each option, the sensitivity of these cash flows, the cost of exercising the option, etc. Understanding the impact of these options on current cash flows would also be important. This could include determining the impact of any non-gaming asset on gaming revenues and cash flows as well as forecasting the future market conditions. This mapping exercise should result in the valuation of each option, the risks associated with these options and a determination if the property is over or under valued based on the options inherent therein.

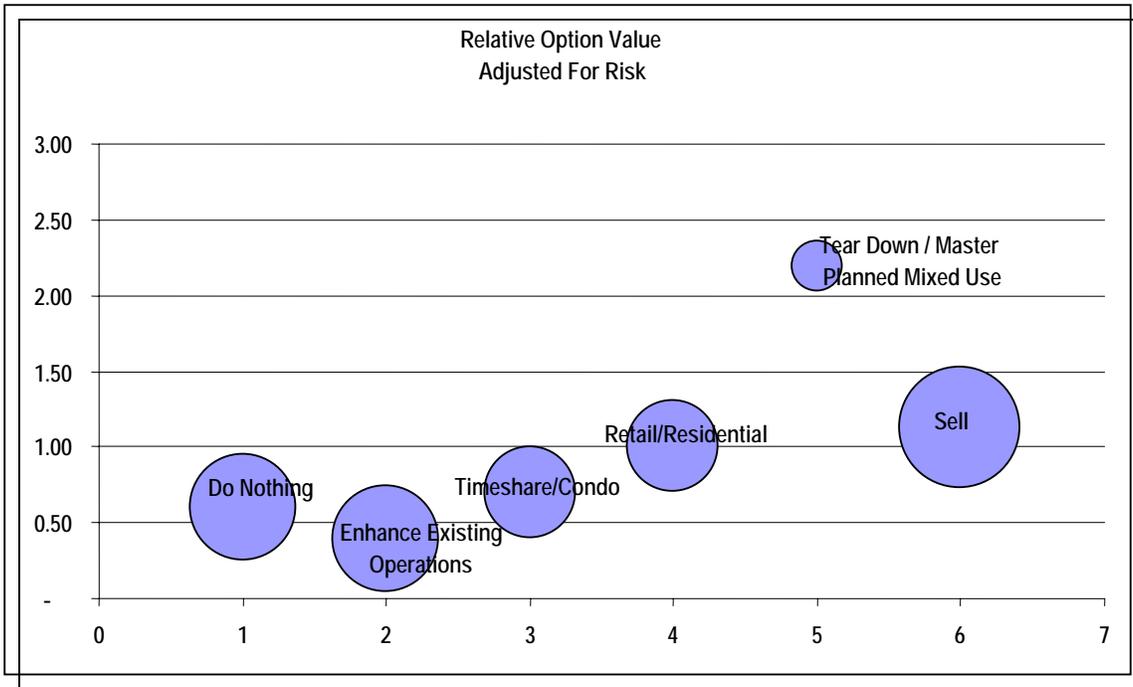
In our example, the options are quantified as follows:

Table 1 – Example of Relative Option Values and Risks

Option	Relative Option Value	Risk (1 – 5)
Do Nothing	.60	2
Enhance Existing Operations	.39	2
Timeshare/Condo	.69	3
Retail/Residential	1.00	3
Tear Down / Master Planned Mix Use	2.19	5
Sell	1.12	1

The relative option values can be arrived at using a number of different methodologies, including Binomial Option Pricing, Modified Black Scholes, etc. After determining the relative option values and adjusting for risk, an option map can be derived to assist management with determining whether it is time to act on the opportunities, or whether there is value in waiting. In the example below, the value of the tear down is highest, but the risk indicates that putting off the decision for some future period might be the best strategy for the time being.

Chart 1 – Option Value Map



Management now has a quantifiable and objective toolset to determine whether or not an option must be exploited, abandoned or whether to simply do nothing. Based on past experience, extracting the value from undeveloped real estate is the key to maintaining the valuation multiples inherent in gaming firm enterprise values. Knowing when and if to pull the trigger on valuable strategic options is more important than ever. 

OPTIMIZING STRATEGIC INVESTMENT

THE KEY TO VALUE CREATION

Most gaming firms today are faced with a conundrum. Wall Street says gaming is a real estate play, and extracting maximum value from the real estate asset is the key to both maintaining current valuations and creating sustainable value in the future. Understanding the relationship between the firms' competitive environment, long term strategy and future investment alternatives and optimizing the portfolio of investments associated with the real estate development will allow gaming operators to create competitive differentiation and maximize value creation.

Competitive Environment and Strategic Positioning – The X and Y Factors

The first step toward optimizing real estate development is to gain an understanding of the competitive environment in which the casino operates. Operating in Atlantic City or Las Vegas is different than operating in Delaware, Pennsylvania or even Spokane Washington. Operating efficiently in a competitive environment such as Atlantic City requires a casino operator to stake out a competitive position and create an asset portfolio that aligns the operation to that position. The Borgata is a good example of this. They created an integrated offering that was unique and superior to anything that existed in Atlantic City before it. Their mix of gaming,

retail, food and entertainment offerings allowed them to gain a superior return on investment. Their strategic investments moving forward are focused on improving their non-gaming offering, adding rooms and food and beverage capacity to take advantage of the growth in these markets. Other operators have been less successful with their strategic investments because they were not well integrated into the existing product or to the marketplace.

In Nevada, Station Casinos has been successful by developing gaming and entertainment destinations geared toward dominating the local gaming market. Their assets include such non-gaming features as movie theaters, family oriented activities, a small room base and better than average food and beverage product.

In less competitive markets such as in some Native American casinos, strategic investments include room product and entertainment offerings geared toward increasing visitation and gaining share from patrons located further distances from the casino.

It is crucial then to master plan for a property that can carve out a competitive position that is sustainable over time and takes into account the needs of the specific marketplace.

patrons offsets the lower amount of gaming positions and drives additional return.

The Optimization Process

Maximizing the return from a master planned gaming and real estate development is similar to creating a stock portfolio. The gaming operator must determine all of the possible real estate uses for their property, the interaction of these uses with the core gaming product and the firms' strategic position, and the market constraints, risks and returns associated with each use. The operator can then design a portfolio of strategic investments that will result in the highest return for the property.

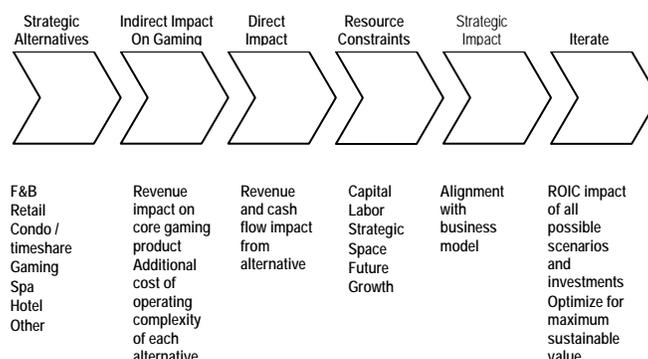
For example, an operator in a new market may attempt to determine the optimal mix of assets to develop in order to maximize returns and leave flexibility and room for expansion. After gaining an understanding of the market potential and constraints for their development, the operator deems that a 2,000 unit casino, with no hotel and limited retail, food and beverage is the least risky strategy to enter the marketplace. Management has set an opening budget of \$350 million. The pro-forma EBITDA and returns are as follows:

Projected Returns from New Casino (\$000's)

Gaming Revenue	\$185.0
Other Revenue	10.0
Total Revenue	195.0
EBITDA	65.0
Investment	350.0
EBITDA Return on Investment	18.6%

Upon further analysis and through an iterative process including market research and operations science, it is determined that the return can be optimized by changing the offering. Management determines that less gaming positions are needed, and since there will be no hotel, additional food and beverage space can be developed in place of some common areas and meeting space. The additional food and beverage asset allows the operator to enhance its offering and attract entertainment seekers, who otherwise would not have visited the property. The gaming revenue from these additional

The process to arrive at this optimal asset mix looks like this:



Projected Returns from New Casino – After Optimization (\$000's)

Gaming Revenue	\$190.0
Other Revenue	18.0
Total Revenue	208.0
EBITDA	70.0
Investment	350.0
Return on Investment	20.0%

The point of this analysis is to challenge conventional wisdom. Most operators, given a fixed budget, will opt to maximize gaming positions and make due with whatever else they can afford. By analyzing the market and the assets that would align with the market, the operator can design an offering that maximizes return on investment and also provides customers with an experience that will ensure their repeat visitation.

As operators embark on enhancements to their existing assets or master plan for the future, analyzing the impact of investment on the core gaming product and overall property performance, can lead to better investment decisions. 

INSIDER'S VIEW

INTERVIEW WITH MICHAEL BOWMAN, VP OF FOOD & BEVERAGE, HARRAH'S, AC

Michael Bowman, Vice President of Food & Beverage for Harrahs Entertainment in Atlantic City provides us with some insight into the future of dining in one of the largest gaming markets.

Q. What do you see as the two or three biggest dining trends in Atlantic City and gaming in general?

A. “In my opinion, Steakhouses (i.e. The Palm, Morton’s, Ruth’s Chris and Gallagher’s). Word has it that Atlantic City can expect two or three more new and exciting Steakhouses. Also, new Bars, Lounges and Ultra Lounges are very popular in Atlantic City.”

Q. Loaded question - Do you see food and beverage as a profit center or as support for the gaming product?

A. “It really depends on the marketing strategy of each individual property. If it’s for reinvestment and the strategy is predominantly about complimentaries, profit is open. If it is retail and cash, it absolutely depends on the market and the overall property strategy.”

Q. Chicken vs. egg question – If there are any high profile F&B failures in Atlantic City, will it set the industry back? Or, in other words, do you think more

rooms are critical to the success of the new F&B offering in Atlantic City?

A. “Weekend business in Atlantic City is not an issue, but rather mid-week business especially in the winter. With the new Pier coming to Caesar’s, the great successes of The Quarter at Tropicana and the Borgata, Food & Beverage will continue to be of high focus. As the market grows, so shall Food & Beverage.”

Q. It seems that most properties in Atlantic City and elsewhere are adding more upscale offerings, clubs, martini bars, etc. Do you think there is room in this or any marketplace for the old style offering (deli, buffet, coffee shop, gourmet room)?

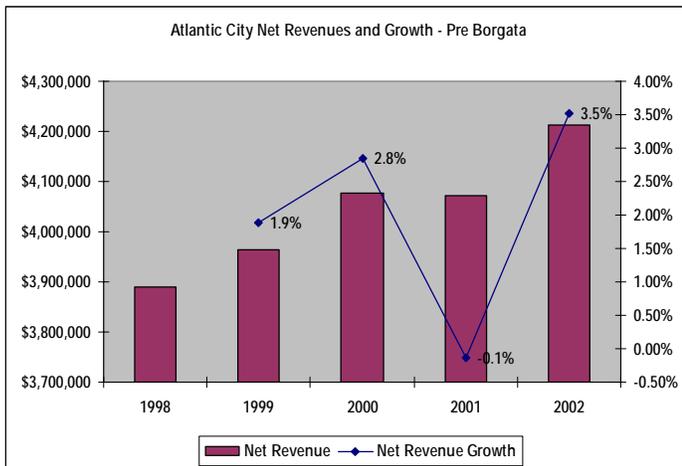
A. “Yes, Food & Beverage trends continue to circle back to the core competencies along with new and exciting concepts. Harrah’s as a company is planning new Buffets, Coffee Shops, Gourmet Restaurants and Player’s Clubs along with great Third Party Operators and core business drivers. As Las Vegas has evolved with Buffet Strategies, we in Atlantic City, have had great success with Buffets at Showboat and Harrah’s. The Deli at Bally’s continues to set records with cover counts and business levels. And of course, every property must have a great Coffee Shop.” 

COMPETITIVE STRATEGY – DEFENDING AGAINST NEW MARKET ENTRANTS

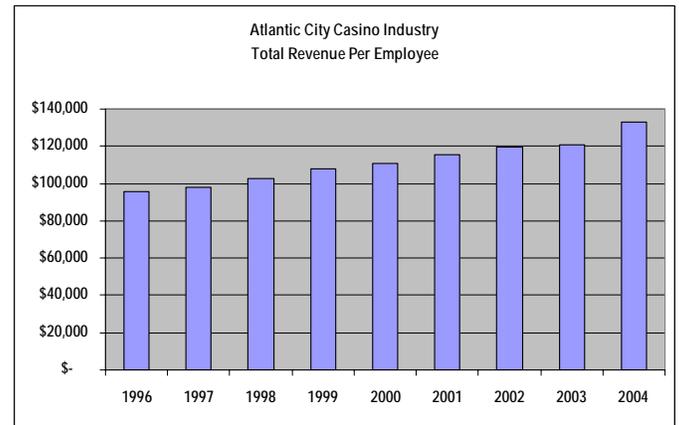
A CASE STUDY

The opening of the Borgata in 2003 changed the competitive landscape in Atlantic City, resulting in significant losses to those properties that waited too long to respond or responded ineffectively, and in favorable returns for those that implemented defensive strategies. There is a good chance that at least one additional competitor will enter the Atlantic City market. Crafting a proper strategy ahead of that new entrant could be the difference between success and failure.

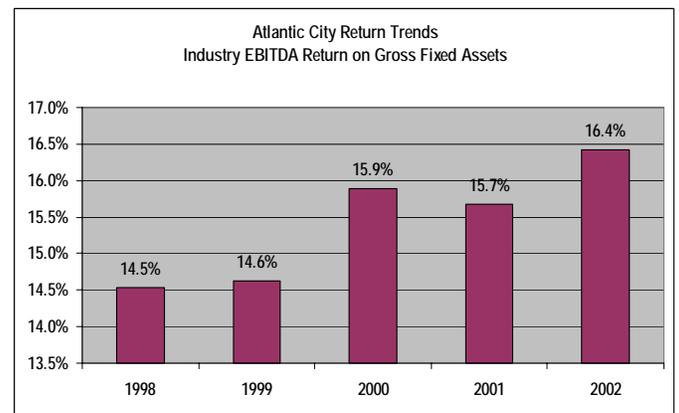
Prior to the Borgata market entry, Atlantic City could be characterized as a stagnant, mature, low growth market, focused primarily on gaming.



Efficiency, measured in terms of total revenue per employee has been increasing steadily, both pre and post Borgata. Prior to Borgata, strategy in Atlantic City focused primarily on efficiency improvements.

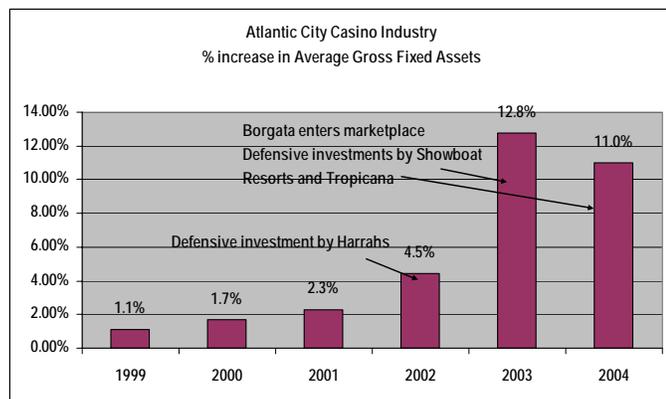


As the industry moved along the efficiency frontier, returns improved annually.



Prior to 2003 (opening of Borgata), investment in fixed assets was relatively low but increasing in anticipation of the Borgata opening. Investment spiked in 2003 and 2004, as Showboat, Resorts and Tropicana increased investment. Showboat and Resorts could be characterized as defensive investments (additional rooms) while the Tropicana

could be characterized as offensive (new retail and entertainment offering).



Since the opening of Borgata, industry returns have declined to 14.1% and 13.4% in 2003 and 2004 respectively, indicating that marginal returns for pre-existing operators were negative and unless the industry can successfully grow both revenues and margins on its existing base, most operators will be faced with declining returns.

A review of incremental EBITDA returns by individual operators reveals some interesting results. We analyzed incremental returns on two levels. First, we measured the increase in EBITDA based on the most recent 12 month period compared to the twelve month period prior to the opening of the Borgata. Then we calculated the incremental EBITDA return on gross fixed asset investment for 2003 and 2004. We compared the incremental return to the average incremental return for the industry after removing the Borgata results and determined the return attributable to the strategic investments made since 2002.

	EBITDA June 2003 TTM	EBITDA September 2005 TTM	Investment 2003-2004	Incremental Return	Return Attributable to Investment
Showboat	112,515,000	139,026,000	104,346,000	25.4%	43.1%
% increase		24%			
% margin	33%	38%			
Borgata	-	255,319,000	1,040,974,000	24.5%	
% increase		NA			
% margin	NA	34%			
Resorts	33,621,000	34,013,000	142,673,000	0.3%	17.9%
% increase		1%			
% margin	16%	14%			
Tropicana	119,965,000	107,618,000	282,971,000	-4.4%	13.3%
% increase		-10%			
% margin	30%	24%			
Sands	14,862,000	12,295,000	23,353,000	-11.0%	6.7%
% increase		-17%			
% margin	8%	7%			
Bally's AC	180,331,000	155,593,000	154,071,000	-16.1%	1.6%
% increase		-14%			
% margin	30%	25%			
Harrah's	191,544,000	167,563,000	90,335,000	-26.5%	-8.9%
% increase		-13%			
% margin	43%	39%			
Trump Marina	60,351,000	52,598,000	25,531,000	-30.4%	-12.7%
% increase		-13%			
% margin	23%	21%			
Caesars	174,295,000	147,637,000	51,471,000	-51.8%	-34.1%
% increase		-15%			
% margin	34%	30%			
Trump Taj Mahal	142,949,000	111,079,000	54,687,000	-58.3%	-40.6%
% increase		-22%			
% margin	28%	24%			
AC Hilton	66,201,000	33,662,000	27,968,000	-116.3%	-98.7%
% increase		-49%			
% margin	22%	13%			
Trump Plaza	76,088,000	37,934,000	26,548,000	-143.7%	-126.1%
% increase					
% margin					
Industry	1,172,722,000	1,254,337,000	2,024,928,000	4.0%	
Industry Without Borgata	1,172,722,000	999,018,000	983,954,000	-17.7%	

The preceding table indicates that EBITDA for the pre Borgata competitors declined by almost \$175 million. Only two competitors realized increases in EBITDA. These results can be explained by the different strategies employed by each of the market participants. The average property in Atlantic City (with Borgata removed) experienced negative incremental returns on fixed asset investments of 17.7% meaning that EBITDA for the average property declined in the face of competition from Borgata, despite investment in capital assets. However, five of these properties (Showboat, Resorts, Tropicana, Sands, Bally's) realized better than average returns and two (Showboat and Resorts) realized positive returns.

The Showboat was the clear leader in return generation, realizing a 25.4% incremental EBITDA return. This can be attributed to both strategy and the type of investment. Showboat spent both offensive

(House of Blues) and defensive capital (rooms). The Showboat property caters to a down market customer, effectively differentiating itself from the Borgata. The House of Blues project helped position the property as an entertainment alternative. Each of these strategies (down-market, rooms and entertainment) allowed it to realize superior incremental cash flows.

Resorts engaged in defensive spending, adding new rooms to capture additional spending from their existing database and mitigate customer defection.

The Sands experience represents a significant shift from their prior strategy to focus the property on slots only. Sands operating profits in the year prior to the opening of the Borgata were depressed. Since that time, Sands management added table games to their property mix and enacted a niche strategy as a down market alternative.

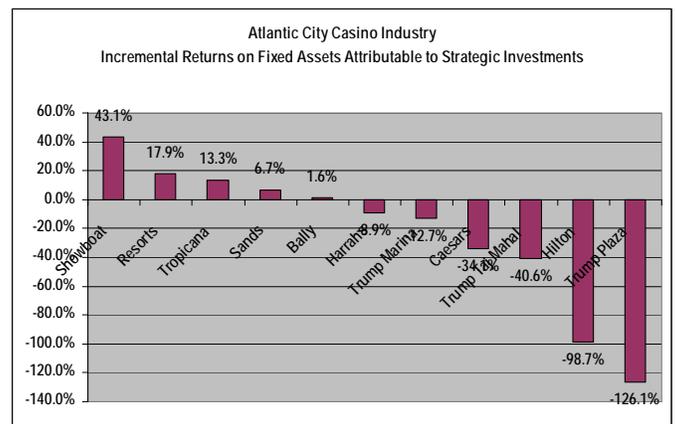
The Tropicana implemented an aggressive offensive strategy to gain revenue and cash flows from previously underserved markets. Their investment in “The Quarter” has resulted in significant revenue increases, but a construction accident, failure to integrate the product into the entire property and delays in opening have resulted in lower returns than projected. However, without this investment, the property would have fared much worse.

Bally’s embarked on a scale economy strategy, purchasing the Claridge and merging its operations into Bally’s. This strategy helped mitigate losses relative to the average decline, but the complexity of the new operation and lack of clear strategic positioning, have left this property at a disadvantage.

Properties that have fared significantly worse are those that either did not invest adequately (Caesars and all three Trump properties) or those that were caught off guard by the market shift to a premium product (Harrahs). Harrahs had implemented its

defensive strategy approximately one year ahead of the opening of the Borgata and realized significant increases in EBITDA during the period leading up to the Borgata market entry. While most of those gains have since been eroded, this strategy did in fact allow Harrahs to maintain the EBITDA level that it had experienced prior to opening its tower in 2002.

The following chart depicts the impact of the various strategies implemented by Atlantic City casinos in anticipation of the Borgata entry.



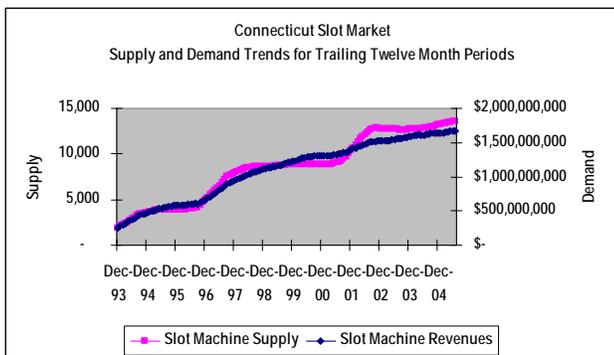
The implications are clear. In the face of new competition, especially a superior product on the scale of a Borgata, doing nothing is not an option. In Atlantic City, the winning strategies were defensive (maintaining existing customers), and niche oriented (down market and not in direct competition with the new player). Offensive strategies geared toward going head to head with the new property were either not successful or marginally so, due to the inability to integrate the new product with the older property features.

Property managers faced with looming competition in Atlantic City and elsewhere must beware. They should make investments wisely and with an understanding of where they will fit within the new competitive framework. ▣

NUMBER CRUNCHING

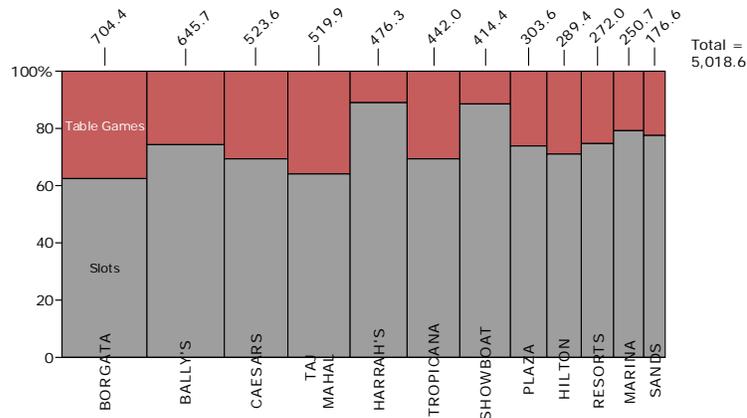
AN ANALYTICAL JOURNEY

Connecticut slot revenue trends are a good proxy for the impact of investment. In many of the jurisdictions that we have studied, revenue growth generally trails investment, and understanding when to make the next investment is paramount to maximizing returns on capital investment. The chart below indicates that investments made in 1996 and 1997 had immediate impacts on the marketplace and that the market was underserved from 1997 through 2001 when the next round of investment was made. However, the 2001 investments did not grow the market at the level of past investments, indicating that the market was maturing. The gap between investment supply and demand has recently widened, indicating an opportunity for further investment.



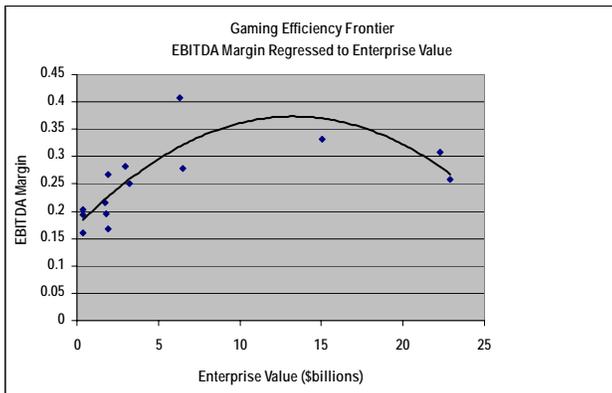
A graphical look at Atlantic City casinos indicates certain strategic biases for under performers and out-performers. Borgata, a clear out-performer in terms

of return on invested capital and total EBITDA, has the highest % of table game revenue relative to total revenues. Two other out-performers, Harrahs and Showboat, each has a clear bias toward slot customers. Taj Mahal is somewhat of an outlier, realizing a significant portion of its revenues from tables, but under-performing in terms of return on investment. The smaller companies at right are all under-performers, and their revenue allocation indicates that none of them have a clear bias toward either slots or tables. While not definitive, this may indicate that in clearly competitive markets, staking out a position on gaming could lead to higher returns on invested capital.



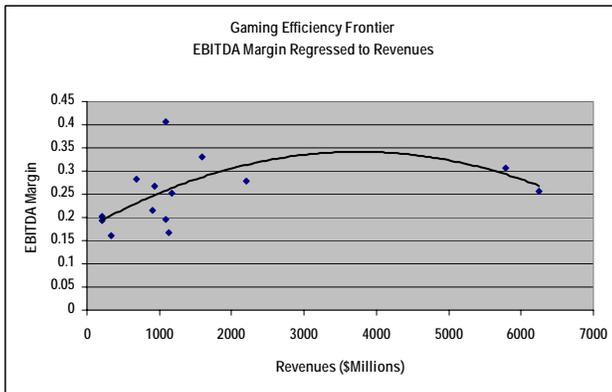
In an era of consolidation, the question begs itself. Is bigger necessarily better? We attempt to answer this

question by comparing size to operating efficiency. We regressed enterprise value to EBITDA margins.



Our prediction? Its only a matter of time before the largest operators either attain required performance levels, or jettison under performing assets. ▣

We also regressed revenues to EBITDA margins.



These analyses yielded interesting results. It appears that in terms of the ability to operate efficiently, firms' peak at about \$12 billion of enterprise value and \$3.5 billion of revenue. Reasons for this include the added complexity of operating several properties with different brands and strategies. The most efficient firm, Stations, has a decidedly consistent locals orientation for its properties.

In terms of return on investment, the jury is out. While we wait for the larger operators to rationalize their recent acquisitions, we can report that the Station historical return hovers around 19% while our projected returns for some of the larger operators are lower than that.