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Challenging TIMES

Navigating bankruptcy and distress in gaming

BY MATT SODL

Consumer spending is the cornerstone of the U.S. economy. Traditionally, it makes up approximately two-thirds of U.S. gross domestic product and is the broadest measure of our nation's financial health.

As we have become painfully aware, however, consumer spending has tumbled throughout the past year, with few segments or regions immune from its effects. Housing. Retail. Restaurants. Hotels. Automobiles. Airlines. Casinos. All of these (interrelated) consumer-driven industries are showing significant signs of distress.

As of December 1, 2008, stock indices for such discretionary segments as gaming and hospitality were down 78.72 percent and 65.28 percent year-to-date, respectively. The resulting economic strain is unlike any seen in recent history, and with no immediate signs of improvement on the horizon (and capital for M&A transactions non-existent), talk of restructuring and bankruptcy is front and center in nearly every major consumer-related sector.

Beyond the widespread factors leading to our current recession (not the least of which is the illiquid credit environment), some businesses are also contending with added segment-specific challenges. The casino industry, for example, was already responding to such complexities as smoking bans and increased competition before the economic downturn became an issue. Additionally, the suitability requirements for gaming ownership/licensure mean that the pool of potential investors to provide junior capital to gaming-related situations is limited. Considering such restrictions against an already-anemic lending backdrop, it is evident that casino owners now forced to restructure will have to walk a much finer line than other consumer-driven companies. The following are some considerations to help casino owners navigate through these challenging times.

How We Got Here

The global economy is just beginning to reveal how pervasive the effects of the financial crisis are. We are indeed in a recession, and for industries like gaming, the impact begins and ends with the consumer and what they are willing and able to spend. And today, quite simply, they are spending less.

Factors such as reduced net worth (due to softened housing market values, historic stock market losses, etc.), uncertainty of job loss/unemployment, and volatility of gas prices have had measurable impact on consumer confidence and risk tolerance. It should be no surprise that discretionary expenditures on such items as travel and entertainment are a low priority for consumers, and that casino properties are seeing reduced visitation and spending as a result. The (multi) million-dollar question then, is, *When will consumer sentiment bounce back?*

The Consumer Mindset for 2009

Gaming industry consultant the Innovation Group recently contributed to a survey conducted by Penn, Schoen & Berland Associates, LLC regarding consumer spending and the gaming industry. Their findings should catch the attention of every casino owner and operator. Over the next 12 months, the survey revealed that 22 percent of active gaming customers polled expect to reduce their number of casino visits, with lower income and infrequent gamers the most likely to be impacted by the current economic environment.

While only 11 percent of higher-income gaming customers responded that they expect to reduce their volume of trips to gaming facilities, related research by the Innovation Group indicates that this consumer segment, along with the most committed of gamers, intends to spend less when they do visit. These negative trends are expected to continue until personal budget considerations, job security and overall consumer confidence improve.

Financial Impact on Casino Operators

As one would expect, the end product of reduced consumer activity for casino properties has been decreased revenues and subsequent (and significant) pressure on operating cash flows and profit margins. In normal circumstances, gaming entities might look for outside capital to help them through such a downturn, but the credit markets are effectively closed for the foreseeable future.

With a number of the largest gaming companies leveraged in the 9X-10X debt/EBITDA range and significant drops in the value of real estate holdings and/or market values, it is not surprising that the credit markets are not eager to provide new debt capital to the industry. Equity sponsors are attempting to buy back their debt and/or improve the terms of their debt tranches to reflect market pricing. Simply stated, the majority of casino entities will not be able to borrow their way out of the liquidity crunch.

Gaming companies are responding by focusing on things they can control—announcing deep cost-cutting measures, reducing staff, and delaying major development projects. But even with these and other related steps, gaming companies are struggling to meet their obligations. The substantial expansion of the industry throughout the past 20 years yielded increasingly elaborate destination resorts that in many cases cost hundreds of millions if not billions of dollars, effectively transitioning countless public and private gaming companies into highly leveraged entities. As a result, gaming entities of all sizes are scrambling to sustain operations, maintain cash liquidity levels, and remain compliant with covenant levels—all while also servicing their substantial debts.

Marc Kieselstein is a partner with Kirkland & Ellis, LLP, a Chicago-based law

firm specializing in complex corporate restructurings. As someone with extensive experience representing debtors and creditors in all aspects of his insolvency practice, he recognizes the significance of established casino companies being denied access to capital.

"Many of those who need rescue financing can't get it right now," Kieselstein observes. "Access to liquidity has dried up, and these entities are being forced to choose between liquidation and bankruptcy. We are seeing the outer bands of the storm, but the worst is yet to come. Many are hoping that the market turnaround comes before they have to choose between servicing their debts and meeting their covenant requirements, but only a select few have that much time on their side."

Indeed, some of these situations have recently come to light.

Trump Entertainment Resorts acknowledged in December that they had to delay a $53 million interest payment on their bonds in an attempt to conserve cash and sustain operations. And they will likely not be the last.

In 2008, Moody's downgraded 17 casino companies and placed 11 more on review for possible downgrade. Even with the "covenant-lite" packages that the relaxed lending standards of the last few years allowed, many gaming entities are proving unable to meet the terms they agreed to in order to obtain their financing. With this perfect storm of highly leveraged balance sheets, reduced revenues, significant competition, and lack of liquidity to cover debts, companies are being forced to review their restructuring alternatives.

The Financial Alternatives

Typically there are three categories of financial alternatives for a company in financial distress: (1) restructuring, which can be informal (negotiated) or formal (with bankruptcy court oversight); (2) orderly sale (363 sale process); and (3) forced liquidation. Next, we focus on a number of these alternatives.

Ideally, all entities would first attempt to amend and/or restructure their debt obligations in an informal manner. This would involve restating the balance sheet to adjust to the current environment, and can be achieved in a consensual manner with creditors, but without the auspices of formal proceedings. It is achieved in a similar in fashion to a financing negotiation.

Unfortunately, discussions with creditors in distressed situations can be unproductive. In the current environment, creditors are taking the opportunity to increase loan pricing to reflect comparable secondary trading levels, and many financial institutions are under significant pressure from their regulators to clean up their loan portfolios. Increasing the pricing level will compensate the creditor with a return that reflects a riskier lending market as well as increasing the value of its loan portfolio.

When communication with debt holders reaches the non-productive point, companies can use more formal/legal protections from those creditors by filing for such protection in bankruptcy court. The bankruptcy code provides companies a 120-day period of protection (known as the exclusivity period) to negotiate a plan of reorganization. After this exclusivity period, competing plans can be put forth to the bankruptcy court, either by a certain creditor group or by a potential third-party bidder. Gaming companies that had filed Chapter 11 as of December 2008 include Greektown Casino (Detroit), Legends Gaming (with properties in Mississippi and Louisiana) and Lake Las Vegas.

Special Considerations for Gaming

Any entity considering restructuring alternatives should consider the inherent legal and procedural conflicts that exist in the heavily regulated gaming industry. Kieselstein describes how federal bankruptcy laws prioritize ways to maximize value and encourage people to invest, an approach which can be in direct contrast to the gaming industry, which, through its state regulators and stringent licensing requirements, overtly aims to limit those that can own and operate a casino.

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"There are many entities and individuals who would be interested in investing in these turnaround opportunities, but they don't want to endure the extensive process of suitability hearings with the state regulatory boards," Kieselstein explains. "It adds a level of extreme selectivity to the process and puts gaming companies trying to turn their operations around at a notable disadvantage. Their list of available resources is very short."

If it becomes clear through the court oversight that a sale of the assets is the best/only way to get creditors repaid, a procedure can be orchestrated (a 363 Sale Process) where the highest and best offer prevails. Given the current economic environment, however, the 363 Sale Process is not discussed extensively here because of the lack of available financing to consummate these transactions.

It is both possible and critical that your plan prioritize making your clientele, staff and suppliers comfortable about sticking with you through the restructuring. If you can't pull that off, the rest is meaningless.

challenged, rationalized and constantly monitored, and budgets and other ongoing goals revisited monthly to reflect current operating trends. Cash flow and covenant levels should also be reviewed monthly, with implementation adjustments made accordingly.

For those entities that will attempt a restructuring, one of the most important commitments a company can make is to address the problem head on with a detailed communication plan. Management must be transparent and deliberate in their actions, responding to both internal and external needs.

According to Steve Rittvo, chairman and CEO of the Innovation Group, appropriate marketing and public relations campaigns must be put in place to provide comfort to those who continue to interact with the company being restructured.

"The fact remains that a formal Chapter 11 brings with it a negative perception," Rittvo says. "Guests will have pointed concerns about the value of their player club points or looseness of the slots, employee morale is sure to be impacted by previous or pending layoffs, and vendors will need reassurance about how they will be paid. It is both possible and critical that your plan prioritize making your clientele, staff and suppliers comfortable about sticking with you through the restructuring. If you can't pull that off, the rest is meaningless."

Rittvo also advises clients against reducing marketing and capital expenditures too significantly.

"Granted, now is not the time to be dreaming big, but a company being restructured needs the basics for quality operations, which include services and facilities that will keep the operation viable against competitors," he says.

Unique Considerations for Indian Country

The balance sheets of Native American-owned gaming enterprises require special consideration as a result of the fact that the U.S. bankruptcy code does not apply to sovereign entities. The courts have ruled that a tribe may waive its sovereign immunity with respect to specific assets of the tribe (or a tribal entity), which are being expressly pledged to satisfy claims resulting from a transaction.

Nevertheless, the title to reservation lands is generally held by the United States of America in trust for the tribe, and under applicable federal law, such tribal trust lands generally may not be sold, taxed or encumbered. Such treatment applies to all real property owned by the tribe on reservations, such as casino buildings, hotels and related improvements. Therefore, lenders to Native American entities are generally limited to perfected security interests in personal property (e.g., slot machines, chairs, tables, and other furniture and equipment) and a pledge of revenues.

The limited nature of tribal borrowers' collateral essentially eliminates a lender's ability to cause a sale or liquidation of assets to pay off outstanding claims in a distressed scenario.

While the legal process surrounding a lender's right to accelerate on a loan to a tribally owned gaming entity has not really been tested to date, as a practical matter, if (and when) such a situation does present itself, lenders and tribes may be best served by working together to devise a long-term operating plan that includes keeping the casino doors open, servicing essential tribal governmental functions, and maximizing annual debt service payments to bring the enterprise back into covenant compliance as quickly as possible.

Additional Finance, Legal and Relationship Considerations

Every gaming operator in this environment should be proactive about heading off potential issues with its debt agreements. Similarly, it is critical that senior management have the foresight to acknowledge problems that are approaching, and that reliable financial advisors and insolvency counsel be engaged early in the process.

If your entity fits the profile being discussed here, every aspect of your operations should be under the microscope—both while considering and implementing restructuring alternatives. Business models and marketing programs should be

Until Then…

Wall Street analysts have their view on when the global markets will start to improve, but the fact is that no one knows how long the economic turmoil will take to cycle through. So long as the negative economic indicators dominate the headlines, gaming operators need to prioritize cost-cutting measures and do all they can to stay current with debt service obligations and covenants.

Management teams should be diligently reviewing their business and marketing plans, and considering improvements at every operational level. If such analysis brings up red flags about the overall health of your organization, you should quickly bring together your team of qualified financial and legal advisors to assist you in outlining your restructuring alternatives.

The current economic environment means that the alternatives available to your organization may not be as diverse as in previous years, but there are workable options that can allow for a restructuring.

Matt Sodl is president, managing director and co-founder of Innovation Capital, an investment banking firm headquartered in Los Angeles. The firm has a practice dedicated to the gaming, leisure and hospitality industries where it provides expert merger and acquisition, corporate finance, restructuring and valuation advisory services to middle market companies in the $20 million to $500 million value range. To receive a copy of the recent webinar presentation "Distress in the Gaming Industry" presented by Innovation Capital, the Innovation Group, Kirkland & Ellis LLP, Bowne and Global Gaming Business*, contact Sodl at msodl@innovation-capital.com or 310-335-9191.*