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# ECONOMIC DIMENSIONS OF THE BID PROCESS FOR LOTTERY GAMING FACILITIES' LICENSES IN THE SOUTH CENTRAL AND NORTHEAST ZONES UNDER THE KANSAS EXPANDED LOTTERY ACT

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## INTRODUCTION

The Review Board, representing the State of Kansas, has experienced a considerably different economic environment in 2009 as compared to 2008 as it has gone through the exercise of allocating Lottery Gaming Facility Licenses to applicants for the South Central and Northeastern Zones. Questions have been raised by some members of the Review Board over how much the State has been disadvantaged by the altered economic circumstances of 2009 in its formal duties of allocating the remaining Zone licenses. Others have asked the consultants to examine the question: "Is this the best project that can be achieved from the perspective of the interests of the State of Kansas?" The purpose of this analysis is to provide some insight on these issues in light of the remaining two applications for Lottery Gaming Facility licenses in Kansas.

The economic recession of 2007-2009, and the dramatic events in the financial markets that were triggered by the subprime mortgage crisis and subsequent financial institution crises over the same period brought about substantial adverse changes to the circumstances confronting most gaming companies. The changed environment also altered perceptions and attitudes about the profitability and viability of casino operations and capital investments in new casino projects in general, especially within the financial community. These altered perceptions have had significant effects on the Kansas bidding process.

## CASINO MARKETS IN GENERAL

Prior to 2008, there was a generally accepted belief that casino gaming in the United States remained a generally under-supplied product. Where gaming was absent, the introduction of casinos would result in relatively predictable revenue generation and participation. In locales with existing mature market casino industries, casino gaming was considered relatively recession-resilient (though not recession-proof) because of the apparent willingness of casino customers to continue spending on gaming in spite of difficult economic times.

However, the severity of the current economic recession and the failure or near-failure of many major financial institutions created a much different environment, with the implication that consumer behavior linked to casino gaming may have changed markedly from its historic patterns. In prior economic recessions, such as 1990-91 and 2001, one could observe slowdowns in the rate of growth of spending on gambling in most gaming markets, but casino gaming revenue performance fared better than many other industries in coming through the recessions.

In discussing trends in the casino industry, it is useful to distinguish between what has happened in Las Vegas and trends in the rest of the United States. For most gaming markets besides Las Vegas, there is a fairly predictable pattern. Legalization of casinos (assuming initially that there is an absence of available casino gaming in the region) leads to an initial period of rapid growth in revenues and high profits; one can refer to this as the “ramp-up” period, and it typically lasts for about five years. Once the market stabilizes, then revenue performance follows a “mature market” status, where future growth in gaming revenues more or less track the growth in aggregate personal incomes in the catchment area.

Individual mature casino markets can be analyzed and adjusted for internal changes in competition (i.e. new casinos opening within that market), external competitive issues (i.e. cross-border competition from casinos in nearby jurisdictions), changes in regulations or constraints governing casino operations (i.e. smoking bans in that jurisdiction or competing jurisdictions; changes in wagering limits, permitted games, permitted hours of operation, etc.) In this manner, gaming revenue performance is relatively predictable, using the general techniques of gravity models and competitive assessment, as has been done on behalf of the Review Board by Wells Gaming Research and Cummings and Associates.

## LAS VEGAS

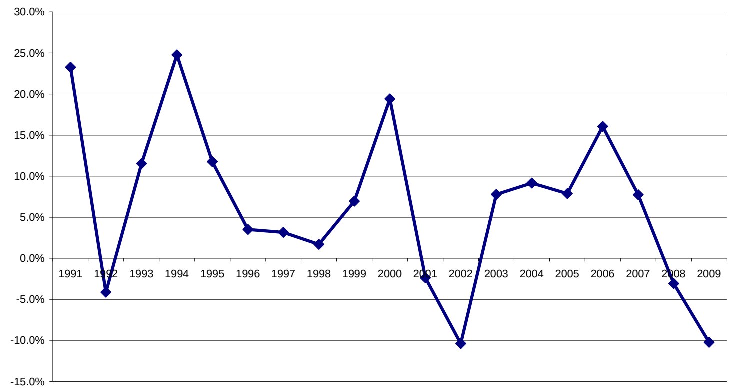
Las Vegas needs to be analyzed differently than other gaming markets. Because it has evolved into a larger, far more diversified, and far more complex destination casino resort area in comparison to any other locale in America, the effects of the economic storms on Las Vegas have been more severe and more dramatic than other gaming destinations in 2008-2009. The importance of looking at Las Vegas, from Kansas’ perspective, is because so many of the potential applicants for all four original Zone licenses have a significant presence in Las Vegas, and most of these have been dramatically affected by that city’s economic downturn. This is likely the primary explanation as to why MGM, Harrah’s, Las Vegas Sands, and Golden Gaming either pulled out of the bidding process in spite of the quality of their proposals in 2008, or chose not to participate for the remaining three Zone licenses in 2009.

As the country’s largest gaming center, between 1989 and 2007, Las Vegas has generated much of its own business cycle, linked to the openings of major new mega-casinos. (See Figure 1.) The pattern that described the fluctuations in gaming revenue growth in Las Vegas over that period can be described as follows: When a new mega-casino or a cluster of such casinos opened, visitation and gaming spend would increase for about a year following the major openings, after which time growth rates would subside to lower (but usually positive) levels. Major clusters of new mega-casinos opened on the Las Vegas Strip in 1989-1990, 1993, 1998-2000, 2005, and 2007-2008.

Interestingly, and to the alarm of the major casino companies, the opening of the $1.8 billion Palazzo in December 2007 and the $2.5 billion Wynn Encore in December 2008, did not create any sign of a "new mega-casino bump." Something had fundamentally changed.

**FIGURE 1**

**LAS VEGAS STRIP ($72 m+) GGR GROWTH RATES, 1991-2009**




The effect of the surprisingly deep reductions in gross gaming revenues in Las Vegas triggered by the recession and financial crisis of 2007-2009 caught many of the major gaming companies in a position where they were substantially over-leveraged. Las Vegas Sands and MGM Mirage were both involved with unprecedented capital investments in the Cotai Strip (Macau: $12 billion) and CityCenter (Las Vegas: $8.5 billion) respectively. Wynn Resorts was building Wynn Encore in Las Vegas ($2.5 billion) and Wynn Encore in Macau ($700 million). Boyd Gaming was developing the $4.5 billion Echelon in Las Vegas. Furthermore, Station Casinos wrapped up a $7 billion Leveraged Buy-Out (LBO) in November 2007, and Harrah's completed a $17 billion LBO in January 2008. Penn National was scheduled to complete its $6.1 billion LBO in June 2008.

Prior to late 2007, the capital markets had viewed the casino industry in a very favorable light. Besides the projects mentioned above, construction was under way for development of the $4 billion Cosmopolitan, adjacent to Bellagio, and the $3 billion Fontainebleau, near the north end of the Las Vegas Strip. Other significant multi-billion dollar projects were on the drawing boards or in the pipeline, driven by the view that Las Vegas could only succeed. Indeed, in 2007 the Elad Group paid $1.25 billion ($35 million per acre for 35 acres) at the site of the former New Frontier Casino on the Strip in anticipation of building a mega-casino modeled on the Plaza Hotel in New York City.

The effect of the dramatic reductions in demand not only for gaming in Las Vegas, but also for non-gaming amenities, created a cash flow crunch for all of the above companies. With the exception of Wynn Resorts and Penn National, the remainder of the above-mentioned companies came very close to bankruptcy as of spring 2009. This is reflected in the share prices of the publicly traded companies, which had declined dramatically between October 2007 and March 2009 as shown below in Table 1.

**TABLE 1**
**SHARE PRICES FOR CASINO COMPANIES**
**OCTOBER 2007 TO MARCH 2009**

| Company | Date | Share Price | Date | Share Price | Change |
|---|---|---|---|---|---|
| MGM | 10/9/07 | 99.75 | 3/6/09 | 1.99 | -98% |
| LVS | 10/8/07 | 138.25 | 3/6/09 | 1.77 | -98.7% |
| Wynn | 10/22/07 | 164.65 | 3/6/09 | 15.40 | -90.6% |
| Boyd | 10/9/07 | 45.25 | 3/6/09 | 2.96 | -93.5% |

Of the companies that attempted LBOs, Station declared Chapter 11 bankruptcy in June 2009, though Harrah's so far has managed to remain solvent. The venture capital partnership that contracted to acquire Penn National, Fortress/Centerbridge, paid about $1.5 billion in July 2008 to negate their contractual obligations to Penn shareholders. This is one of the primary reasons why Penn National has ended up with a strong balance sheet in 2009.

As a result of the recession and financial crisis, most of the major gaming companies were effectively removed as potential competitors for bidding on the various Kansas Lottery Gaming Facility licenses in 2009. One could extend the list to include Golden Gaming, whose primary assets have likely been compromised by the Station bankruptcy filing and legal actions subsequent to that. The withdrawal of Foxwood's as a bidder in 2009 is certainly related to their financial difficulties concerning existing debt, declining cash flows, and political pressures within the Pequot tribe to keep distributions (i.e. dividends) close to their historic levels.

In summary, the pool of potentially competent, interested, and eligible companies that otherwise may have competed for valuable Lottery Gaming Facility licenses in Kansas was decimated by the economic events of the past 24 months. That led to the situation where now there remains only a single applicant each for the South Central and Northeastern Zones, and no applicant for the Southeastern Zone.

## THE ECONOMIC CIRCUMSTANCES FOR THE ZONE BIDS IN KANSAS

In spite of the turmoil in the national economy and the financial stress experienced by so many gaming companies, there has not been much change in the underlying economic realities associated with the potential value of the Lottery Gaming Facility licenses for Sumner and Wyandotte Counties from 2007 to the present. (This is reflected in the estimated gaming revenue generation and visitation for proposed casino projects in the Northeast Zone and South Central Zone in 2008 and 2009 by Wells Gaming Research, summarized in Table 2 and Table 3.) In Sumner County, the winning bidder will receive an exclusive right to offer casino gaming services in the general Wichita metropolitan area, with only a low probability that such a geographic monopoly could be disturbed either by slots at a race track in Wichita or by a tribal casino in the Wichita area. Such a gaming license has substantial potential economic value, not much different than was the case in 2007-2008. In Wyandotte County, the Lottery Gaming Facility license would permit its holder to build a purpose-built land-based casino entertainment complex that could compete very well against the existing four riverboat casino operations in the Kansas City, Missouri marketplace.

**TABLE 2**
**PROPOSALS FOR NORTHEAST ZONE, 2008 AND 2009**
**PHASE 1 SIZE, VISITATION, AND PROJECTED GAMING REVENUES**
**(IN 2013)**

| Capacities & Amenities | Kansas Entertainment Phase 1 (2009 bid) | Legends Sun (2008 bid ) | Pinnacle Entertainment (2008 bid) | Golden Heartland Phase 1 (2008 bid) | Kansas Entertainment Hard Rock (2008 bid) |
|---|---|---|---|---|---|
| **Capital Investment** | $361,000,000 | $767,000,000 | $650,000,000 | $660,000,000 | $706,000,000 |
| **Gaming Revenues:** | $156,000,000 | $168,000,000 | $199,000,000 | $184,000,000 | $234,000,000 |
| **Visitor Projections:** | 2.1 million | 2.3 million | 2.7 million | 2.5 million | 3.1 million |
| **Casino:** | | | | | |
| Square Footage | 100,000 | 131,000 | 100,000 | 132,000 | 125,100 |
| # of Slots | 2,300 | 2,000 | 2,300 | 2,500 | 3,000 |
| # of Table Games | 61 | 60 | 60 | 80 | 90 |
| # of Poker tables | 25 | 25 | 25 | 18 | 50 |
| **Hotel Rooms** | 0 | 350 | 500 | 300 | 300 |

Source: Wells Gaming Research

**TABLE 3**
**PROPOSALS FOR SOUTH CENTRAL ZONE, 2008 AND 2009**
**PHASE 1 SIZE, VISITATION, AND PROJECTED GAMING REVENUES**
**(IN 2013)**

| Capacities & Amenities | Chisholm Creek Phase I (2009 bid) | Harrah's Phase 1 (2008 bid) | Marvel's Trailhead (2008 bid) | Penn National's Hollywood (2008 bid) |
|---|---|---|---|---|
| **Capital Investment** | $125,000,000 | $450,000,000 | $393,000,000 | $365,000,000 |
| **Gaming Revenues:** | $144,000,000 | $210,000,000 | $143,000,000 | $129,000,000 |
| **Visitor Projections:** | 2.0 million | 2.9 million | 1.8 million | 1.7 million |
| **Casino:** | | | | |
| Square Footage | 54,475 | 70,000 | 65,000 | 70,000 |
| # of Slots | 1,300 | 2,000 | 2,000 | 1,500 |
| # of Table games | 30 | 50 | 65 | 40 |
| # of Poker tables | Not Specified | 9 | 18 | Not Specified |
| **Hotel Rooms** | 0 | 365 | 304 | 350 |

Source: Wells Gaming Research

For both the Wyandotte County and Sumner County bids in 2009, the following observations can be made. First, the reduction in the number of bidders from three to one in each Zone creates a situation where the State is disadvantaged in terms of its ability to extract additional economic rents in the form of "sweeteners" from the winning bidders. In a competitive bidding environment, applicant companies would look at the prospect of having an exclusive license and prepare their proposals in terms of what would maximize their expected profitability for such a license; then they would provide additional dimensions to their proposals which could not otherwise be justified on a profitability basis, but which would enhance their chances of winning the bid. In this manner, competing applicants would add incremental dimensions—"sweeteners"—to their proposals which (in their judgment) would make their projects more attractive to the State's decision-makers.

This pattern was apparent with the bids that were submitted in the fall of 2007 and contested during the Review Board process over the summer of 2008. For example, in 2008, it may have been difficult for bidding companies in both Sumner and Wyandotte Counties to justify the number of hotel rooms proposed, golf courses, themed and branded restaurants, enclosed parking, and other sweeteners on strictly a *Return on Invested Capital* (ROIC) basis. However, such add-ons made particular projects apparently more attractive than they otherwise would have been to decision-makers, and thereby enhanced the likelihood of specific bidders winning the votes of members of the Review Board.

In a non-competitive bidding environment, the motivation to put forward a proposal that will maximize the expected profitability for the applicant for the license remains. However, there is no incentive to offer sweeteners (as defined above) except to reduce the risk that the application might be deemed unacceptable to the Review Board members. Thus, the effective net loss for the State of Kansas is a weakening of its bargaining power that otherwise might have resulted in sweeteners that would enhance the value of the winning applications for the State of Kansas in terms of, say, greater tourist drawing power.

If the remaining applicants were bidding for the two Zone licenses in a normal economic environment, then one could expect that they would put forward applications that would maximize the value of their respective capital investments in light of the anticipated market conditions, based on their respective professional judgments and assessments. In other words, the Sumner County bid should reflect what a profit-maximizing gaming company would develop if it were granted a monopoly license in that marketplace, and the Wyandotte County bid would reflect what a profit-maximizing gaming company would develop if it were granted an exclusive license in that somewhat more competitive marketplace.

However, 2009 is not a normal economic environment, especially with respect to the availability of debt financing at a reasonable rate. According to conversations with representatives of financial institutions with track records of financing casino developments, there is very little financing presently available for “green field” casino projects regardless of their economic potential. Thus, the Chisholm Creek proposal has put forward an “all cash” bid that will require no debt financing. The Kansas Entertainment proposal hopes to fully finance its project, but in their responses, they have indicated they will provide 100% equity financing if need be. In all likelihood, constraints on capital resulted in Phase 1 proposals that are smaller than projects that would optimize the return on invested capital for both Zones.

If the applicants can be trusted to be competent and stable self-interested casino gaming owners and operators, and if they are deemed capable of constructing their Phase 1 facilities, then even if they begin their casino operations with facilities that are smaller and less endowed than what would be optimal for themselves, it can be reasonably expected that, once their gaming facilities are in operation and generating positive cash flow, they will be able to generate reasonably priced debt financing for further expansions to move closer to an optimal configuration. (In anticipation of this eventuality, the Consulting Team decided to develop the *Raving Consulting Alternative Minimum Casino Resort Scenario*. Though this is not necessarily the optimal size of a gaming facility in light of the anticipated market conditions, it is undoubtedly closer to the optimum than the capital constrained Phase 1 proposals from both remaining applicants.)

## CAN HOTEL ROOMS BE CONSIDERED "SWEETENERS"?

The capital constrained and non-competitive applications for the South Central Zone and the Northeast Zone have resulted in Phase 1 applications that do not contain any hotel rooms. This raises two important questions that the Review Board needs to contemplate related to the legal mandate of the Kansas Expanded Lottery Act (2007), which states that the Review Board should "… determine which contract best maximizes revenue, encourages tourism and otherwise serves the interests of the people of Kansas." First, can one argue that a Lottery Gaming Facility without hotel rooms can reasonably be considered to "encourage tourism?" Second, if gaming licenses are granted to the applicants where they have no legal obligation to build hotel rooms, can we expect to see hotel rooms built by the applicants as part of a strategy to maximize their expected future earnings from the projects?

On the tourism question, a Lottery Gaming Facility without hotel rooms is clearly not as tourist-friendly as one that has hotel rooms. Nonetheless, such a facility would still encourage tourism to the extent that out-of-state customers would visit the casino as day-trip-visitors, or as overnight visitors who would utilize other hotel accommodations. In the Kansas City, Kansas market, a Lottery Gaming Facility would draw a significant number of Missouri visitors from the Kansas City, Missouri metropolitan market with or without a hotel. In the general Wichita market, a Lottery Gaming Facility in Mulvane would attract some customers from Oklahoma, as well as other out-of-state residents who were visiting the Wichita area. Empirical estimates of such visitation can be found in the Wells, Cummings, and Civic Economics consultant reports.

For the second question, the answer is less clear. Both Zone casinos are going to be predominantly "local and regional market" casinos, in the sense that a very high proportion of the spending done at those facilities will come from residents of the respective metropolitan areas regardless of the addition of a hotel. Whether it is in the financial interests of a license holder to build hotel rooms in either case depends on the trade-offs inherent between the costs of construction of hotel facilities versus the anticipated incremental revenues (gaming and non-gaming) that can be expected with a hotel of a specified size (in number of hotel rooms) and quality. Many casinos in limited competition marketplaces provide a moderate number of hotel rooms to cater to their "best customers" as well as to those who prefer to spend the evening, even though they may live within reasonable distance of the casino. Some insights into this question can be provided by looking at casinos in other monopoly or limited competition markets, and noting whether or not they chose to build hotel rooms (when they were not obligated by conditions of their licenses to do so.)

Table 4 provides a sampling of various casinos that experience limited competition in their marketplaces and are located within short driving distances of metropolitan markets; the Table reports the number of slot machines and hotel rooms at their facilities. Some of these casinos with no hotel rooms have indicated that they have long-term plans to develop hotel rooms. The others with hotel rooms offer only a moderate number of rooms in comparison to the proposals that the Review Board saw in 2008, suggesting that, at least for that bidding cycle, many of the hotel rooms proposed were offered as "sweeteners." Thus, should either or both of the applicants be given licenses for their proposals, the number of hotel rooms that would ultimately be developed will not likely exceed 200 in either venue.

**TABLE 4**
**SELECT CASINOS, SLOT MACHINE COUNTS, AND HOTEL ROOM COUNTS**

| CASINO | LOCATION | NUMBER OF SLOT MACHINES | NUMBER OF HOTEL ROOMS |
|---|---|---|---|
| Thunder Valley | Sacramento, CA | 3,200 | 0 |
| Cache Creek | Brooks, CA | 3,130 | 200 |
| Red Hawk | Shingle Springs, CA | 2,122 | 0 |
| Jackson Rancheria | Jackson, CA | 1,525 | 146 |
| Par-a-Dice | East Peoria, IL | 1,100 | 201 |
| Grand Victoria | Rising Sun, IN | 1,371 | 201 |
| Belle Terra | Belle Terra, IN | 1,600 | 297 |
| Empress | Joliet, IL | 1,194 | 100 |
| Horseshoe | Hammond, IN | 3,200 | 0 |
| Mystic Lakes | Prior Lake, MN | 4,500 | 586 |

Source: www.casinocity.com

**WHAT IF THE REVIEW BOARD DECIDES NOT TO AWARD LICENSES?**

One possibility with one or both Zones is that the Review Board might decide the present application is not adequate in terms of "…best maximizing revenue, encouraging tourism and otherwise serving the interests of the people of Kansas." If the applications were sent back to the Kansas Lottery for renegotiation, it is difficult to predict how long it would take before new or revised applications could be successfully negotiated with the Lottery, and if so, whether they would result in substantial improvements for the State of Kansas.

In light of the above discussion, if the current applications are deemed inadequate by the Board, it would likely be because, in the opinion of the Board, there was an absence of competition in the bidding process resulting in less (or no) "sweeteners," and thus did not encourage *enough* tourism and maximize revenue and other benefits for the State of Kansas..

It is possible that renegotiation might lead to a re-opening of the "Request for Proposal" process, which might increase the pool of applicants. However, it is difficult to predict whether this would result in a substantive improvement (from the perspective of the Review Board) in the quantitative and qualitative dimensions of future negotiated contract applications. It is reasonable to assume that the issue of the availability of debt capital at reasonable rates will only improve as the economy normalizes and the national economic recession transforms into a substantial recovery.

What can be said with some degree of certainty is that if one or both of the current applications are not successful, then the opening of Lottery Gaming Facilities in one or both of the Zones would be delayed, perhaps by between 18 and 36 months (or perhaps indefinitely), depending on the vagaries of the process. (It is possible that, if the current applicants are not successful, the State may choose not to repeat the bidding process one more time.)

The cost to the State of Kansas, in terms of tax revenues foregone because of the absence of gaming operations, can be roughly estimated for delays of various lengths. Based on the Extended Kansas Lottery Act, the State of Kansas is not only the technical owner of the Lottery Gaming Facility, but because it is entitled to 22% of the gaming revenues, it is the largest potential beneficiary from a financial perspective. (Another 5% of gaming revenues would accrue to local governments and to problem gambling treatment and substance abuse programs.)

Based on revenue estimates provided by Wells Gaming Research and Cummings & Associates, the Phase 1 projects in Sumner and Wyandotte Counties would generate annualized Gross Gaming Revenues of about $144 million and $156 million respectively (in 2013 dollars). The State's annual share of these revenues would be about $66 million per annum. Thus, a delay of one, two or three years in the opening of both casinos, under the simplest analysis, would result in foregone revenues to the State of Kansas of about $66 million, $132 million, or $198 million, respectively.

A more thorough analysis of the fiscal implications of delay of granting licenses to the South Central and Northeast Zones can be determined by extrapolating the fiscal impacts as put forward by the Meridian Business Advisors report. Based on their analysis, once both casinos are in full operation, taxes from all sources (gaming, sales, income and property) will contribute approximately $83 million per annum to the State of Kansas, and an additional $16 million to the counties and special districts. (This breaks down into $45 million to the State and $10 million to the Unified Government in Wyandotte County, and $38 million to the State and $6 million to Sumner and Sedgwick Counties, and school and fire districts from the Chisholm Creek project.) Estimated costs associated with the new casinos would be negligible at the State level, about 5% of Unified Government revenues for Wyandotte County, and about 40% of local government revenues for Sumner and Sedgwick Counties. Thus, the annualized net loss to state and local governments of postponing the projects per annum would be in the range of about $95 million.

Finally, based on the findings of Civic Economics, new spending in Kansas brought about by the Phase 1 casinos (in terms of export (tourist) spending and import substitution) would be $190 million per annum in 2013 dollars ($126 million for Kansas Entertainment and $64 million for Chisholm Creek.) This injection of new spending into the Kansas economy is the most important long term contributor to new job creation and economic growth linked to the Lottery Gaming Facility projects.

## CONCLUSIONS

In light of the unusual events that led up to the bidding process for the South Central and Northeastern Zones in 2009, the Review Board should weigh and evaluate the following questions:

1. Do the project applications, as presented, meet the minimum standards and objectives of the law?
2. Are the applicants able to build their Phase 1 proposals on an all equity basis without having to access debt financing?
3. Once operations are under way, will the applicants have the ability and willingness to develop the Lottery Gaming Facilities to their fullest potential, in terms of maximizing the value of the licenses for the applicants themselves? If so, how long will that take?
4. Does the evidence show that the State would be demonstrably better off by accepting either or both of the applications?
5. Might the State be better off by sending the applications back to the Lottery for renegotiation until the proposals reflect what could occur in a competitive bidding environment with normal economic conditions? If they did, how long would the projects be delayed, and what is the risk they would be permanently cancelled? What would be the total costs of delay if that avenue was pursued?

In light of the fact that for each Zone under consideration, there is only one applicant, the Review board members must vote “yes” or “no” on that applicant. Carefully answering the above questions based on all the evidence and analysis produced by the applicants and the Review Board consultants should be useful in coming to appropriate decisions.