Red Rock Resorts' Second Class IPO

Good afternoon and welcome to the Unauthorized Roadshow for Red Rock Resorts' second class IPO. For more than 20 years, we have followed and analyzed Station Casinos, now called Red Rock Resorts. We believe we bring a unique, local perspective on this company, including some issues you won't find in the offering prospectus or the company's road show presentation.

Full disclosure: our union represents 60,000 gaming workers in Las Vegas, and we have a labor dispute with Station Casinos.

Today we will walk you through a critical look at the structure and terms of the IPO and introduce you to some questions about the company's growth prospects. You can follow along with the deck on your screen, and the slideshow is also available at our website: rrripodissected.org.

We consider Red Rock's IPO second class because, in contrast to the recent IPO by a leading gaming company, this IPO is not investing in the future of the company. It is not investing in Las Vegas. It does not reduce Station Casinos' debt, nor does it fund any expansion plans or strategic acquisitions. Instead, the IPO is being done to fund the acquisition of an insiders' management company, and new investors who pay for it will get second class shares in return.

Slide 2 Red Rock Resorts is a new parent company of Station Casinos, whose business is dominated by casinos catering to Las Vegas residents. It emerged from bankruptcy in 2011 after a leveraged buyout, and is now 58% owned by the Fertitta Family and 25% owned by Deutsche Bank, one of the lead underwriters of this IPO.

Slide 3 Red Rock will only own a third of the economic interest in Station Casinos.

Slide 4 New investors will only have 7% of voting power, and receive 15% of tax benefits under a tax receivable agreement, while owning 33% of economic interest.

Slide 5 So the structure poses some questions. First and foremost, is the $460 million price for Fertitta Entertainment excessive? Will there be enough cash for dividends after Red Rock makes its required tax receivable payments to pre-IPO owners? How soon will Deutsche Bank sell its entire stake and will there be an overhang or dilution when that happens?

On the operational side, what <u>are</u> the growth prospects for Red Rock's core business? We will share economic data from the ground in Las Vegas and highlight some issues about the company's tribal gaming franchise.

Slide 6 Even though the company doesn't talk much about the Fertitta Entertainment acquisition in their roadshow, it is the primary use of IPO proceeds. The only business of Fertitta Entertainment is managing all of Station Casinos' properties, and it is owned primarily by the Fertitta family. We looked at the $460 million price tag to buy the company and the valuation appears very high:

The price is almost 9 times its annual management fee. Yet Fertitta Entertainment's management agreements covering at least 13 of 19 Station casinos provide for a termination fee of only 1 year's management fee if these casinos are sold to a third party. Why should public investors be asked to pay 9 times the termination fee provided in the agreements? Also, in our experience, 3x annual management fees is common as a termination fee for arm's-length management contracts in the hospitality industry.

Slide 7 By other measures, too, this $460 million buyout is highly priced.

It represents 20% of the company's equity value at the mid-point of the offering's price range.

And it is <u>31 times</u> Fertitta Entertainment's estimated EBITDA, for a management business that will cease to exist after the acquisition. <u>31 times EBITDA</u>. By contrast, Starwood Hotels – a worldwide hospitality management company – was bought at 13x EBITDA after a surprise bidding war just this month.

We calculated Fertitta Entertainment's EBITDA ourselves by comparing financial statements filed by Red Rock and those filed by Station Casinos. If you are interested in our calculations, feel free to contact us afterwards.

The financial statements of Red Rock in the prospectus do not show any benefits from the Fertitta Entertainment transaction. We expect there is some benefit, but we question the cost.

It's worth noting that Fertitta Entertainment did not have audited financial statements at the time the purchase agreement was signed – a fact that was disclosed in the purchase agreement. We've sent a letter to the SEC about some questions about this, and you can see our letter on our website.

For some perspective, back in 2006, when the company was last publicly traded and about the same size as it is now in terms of net revenues, its corporate expense was over $60 million, so we question how much lower corporate expense will be than the $53 million management fee paid to Fertitta Entertainment in 2015.

Slide 8 And this $460 million acquisition is an all cash transaction. In the last few years, the Fertittas and other insiders have taken large amounts of money out of Station Casinos.

Station Casinos was unsuccessful in getting permission from bondholders last spring to borrow $300 million to pay a special dividend. We raise this as a reminder that debt plays a restrictive role in this company and it is not being refinanced or reduced by the offering.

Even without the dividend recap, Station Casinos has paid more than $470 million to its owners since 2013. Just this month, they paid out $40 million to owners. With the $460 million Fertitta Entertainment purchase, that would add up to cash outflow of over $930 million over 3 years – for a company with a $2.3 billion market cap based on the projected IPO valuation and $2.2 billion of debt on its balance sheet.

We also note that Fertitta Entertainment bought a $30 million private jet on the eve of the IPO filing, and the Fertitta family will keep the jet while the debt will be paid off as part of the Fertitta Entertainment deal.

<u>Slide 9</u> Knowing what we know about the local economy in Las Vegas, we can't help but put all this cashing out in the context of concerns about where the growth of Red Rock's business will come from in the future. That's the $460 million question: what are you buying?

Red Rock caters to Las Vegas local residents - what is called the Las Vegas Locals market. We compared data from the Nevada Gaming Control Board and other economic sources to analyze Red Rock's growth picture.

There has been little growth in overall gaming revenue in the Las Vegas locals gaming market since 2009. And Station Casinos has not noticeably gained market share.

Slide 10 Revenues from slot machines comprise 80-85% of Red Rock's casino revenues. But there is outright contraction in the number of slot machines in the Las Vegas Locals' gaming market. And this is true at Red Rock's 9 major casinos, too, where the total number of slots is down 9.6% since 2009. Historically, casinos put more slot machines on the floor when customers are spending more on slots.

Slide 11 The company shows lots of economic indicators to paint a picture of Las Vegas' current economic recovery. But what is the quality of the current recovery? To answer that question, we compared economic data in Las Vegas for the years following the last two economic recessions: ending in 2001 and 2009. We think you will agree that the differences are stark:

Between 2002 and 2006, Las Vegas population, employment and average weekly wages all went up roughly 20%.

By contrast between 2011 and 2015, average weekly wages only increased 3.6%, and employment grew by 13.5%.

These data are correlated to local slot play. In the earlier economic recovery – the one which fueled Station Casinos' growth – the average monthly slot handle increased a whopping $20 million. In this latest economic recovery, average monthly slot handle has increased by just $0.7 million.

Las Vegas was one of the hardest hit metropolitan areas by the Great Recession's foreclosure crisis, the subprime lending crisis, and tourism and employment contraction. The recovery right now is slow and long, and doesn't look like the recovery from the previous recession, which coincided with significant expansion of the Las Vegas locals market.

Slide 12 If the Las Vegas locals market has reached an inflection point and is about to take off, why is Red Rock selling its specially zoned casino development sites? You have no doubt read in the prospectus and heard from the company that Station Casinos has taken advantage of a Nevada law that restricts new neighborhood casinos from being developed and has bought up the only available future casino sites so that they "own and control" their own destiny. So why are they selling some of these sites now? Is it a reflection of what those economic numbers could be telling them about the future of their core business?

Slide 13 The other cash flow generator for Red Rock is tribal gaming management contracts. Two tribal agreements generated $88 million in adjusted EBITDA for 2015, or 14% of the total. One of these expires in 2018, the other in 2020. Federal law limited tribal management agreements to 7 years, and some tribes bring on a gaming management company for one term to set up operations until they can run the casino themselves. Station's first management agreement for a tribal casino was terminated at the end of one term in 2010 and not renewed. While there is one more tribal casino project in the pipeline, that's all the company has in the pipeline now. Station Casinos has not signed a new development or management agreement with a tribe since 2004. Station Casinos' Chief Development Officer back then is no longer with the company. His own firm currently manages several tribal casino resorts across the U.S.

A last word on growth, and we don't have a slide to show because that's the point. Station Casinos has not entered any commercial gaming market outside of Nevada since it had to leave Missouri in 2000, while the gaming industry has expanded into many more new states since then. If investors seek a gaming company that can expand into multiple commercial markets outside of Las Vegas, be sure to ask Red Rock management what happened in Missouri. Station also aborted its online gaming venture within 2 years. *But for* tribal gaming, Station has been landlocked in Nevada.

All of these facts seem to warrant the classic warning for prospective investors: Do you want to put all your eggs in one gaming basket?

Slide 14 And at the Gaming Control Board meeting in January, the company publicly admitted to not having any concrete development plans while they do this IPO.

Slide 15 So if the price to buy out Fertitta Entertainment is high, and Red Rock's growth in its core market is slow, what are investors getting? You might think you are getting a dividend stock with a 2% or so dividend yield. But you should remember: Red Rock only gets a third of economic interest in Station Casinos, so with any distributions made to owners, two thirds will go to the Fertittas and other pre-IPO owners, if they stay around. Further, under the Tax Receivable Agreement, Red Rock has to make cash payments to the pre-IPO owners before it can make any dividends to its second-class Class A shareholders. The amount pre-IPO owners get equals 85% of certain tax benefits thanks to the Up-C IPO structure, which is designed to help them and Red Rock save on taxes. It appears to be an entirely arbitrary convention that pre-IPO owners get 85% of these tax benefits under a TRA. But because there is no cap, these future TRA payments could have what Red Rock calls a "material negative effect" on liquidity.

Slide 16 We looked at some examples of what can happen to estimates of TRA payments after other IPOs. In these cases, they grew considerably. The more of Station's old shares that are converted and sold, the higher the tax receivable payouts, based on Red Rock's disclosure about what happens to these payments if the underwriters exercise their options to sell additional shares. For example, the winding down of Deutsche Bank's or other shareholders' positions may reduce the amount of Red Rock's available cash under this agreement.

Slide 17 Existing shareholders are selling few shares in the IPO, but one of them is under significant pressure to sell off its entire stake. Deutsche Bank has been selling off its no-core assets left and right. The prospectus shows that Deutsche will have 16-18% of beneficial ownership after the IPO. How long before Deutsche Bank unwinds its entire holding in Station Casinos by selling shares on the market? Will this potential create an overhang on Red Rock's share price or depress the price upon sale? Will the 180-day lock-up period be waived, by underwriters, including Deutsche Bank?

This is not an academic suggestion: Just three months ago, DB's new co-CEO John Cryan wrote a memo to client relations staff insisting its balance sheet was "rock-solid," as the price for Deutsche's credit default swaps rose during a market reaction reminiscent of 2008. At the bank's January earnings conference, Mr. Cryan specifically noted the bank's efforts to sell its stake in Station Casinos.

Slide 18 Investor pressure on Deutsche Bank follows years of regulatory and legal problems, including an affiliate who pled guilty to criminal wire fraud and paid $2.5 billion in fines to US and European financial regulators. Deutsche's troubles include ongoing investigations into possible money laundering. A felony plea and potential money laundering investigations are inconsistent with ownership in Nevada's highly-regulated gaming industry. Nevada state law states that "gaming is free from criminal and corruptive elements." Nevada regulators have never called Deutsche Bank forward for suitability, and if they did, Deutsche Bank might choose to sell its shares quickly.

Slide 19 Last but not least, there are serious corporate governance issues at Red Rock, which make new investors second class shareholders. Will this create another overhang on the shares post-IPO? The Fertittas will control all corporate decisions with 10:1 voting rights and a host of anti-takeover measures. The Council of Institutional Investors noticed these problems and recently cited Red Rock as an example of what is wrong with IPOs with no sunset provision on dual class voting rights or supermajority voting requirements. We believe these second-class provisions should be eliminated before the offering is consummated, so that public investors have a means to hold management accountable on their ability to grow Red Rock's business from here.

There is also a growing corporate governance critique of long-serving board directors, which certainly applies to Station Casinos. Two of the board directors have been with the company or its predecessors for over a decade. But of course, public shareholders will not have any way to change the board with the second-class shares they will buy in this IPO.

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Red Rock's IPO is a second class gaming IPO. It does not invest in growth, it does not reduce restrictive debt, and it does not invest in Las Vegas, which represents 85% of EBITDA for the company. Your investment buys out Fertitta Entertainment at 31x our estimate of its EBITDA. New shareholders get second class voting rights and no control. Dividends will be second to payments made under the Tax Receivable Agreement that overwhelmingly benefits pre-IPO owners. Fundamentally, and arguably most importantly, Red Rock Resorts' growth prospects are tempered by slow growth in its dominant market.

Thank you for joining us today.