Red Rock Resorts/Station Casinos
IPO DISSECTED

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IPO with a TRA: Outside Investors Should Demand a Cap on Cash Payments to Insiders

Red Rock Resorts is planning an IPO with a tax receivable agreement. This agreement presents a risk to outside investors because it requires the public company to pay out a substantial (and potentially unlimited) amount of cash to the pre-IPO owners – the Fertittas and others – for years after the IPO. Investors should demand a cap on the TRA payments to protect themselves and Red Rock Resorts against potentially unlimited exposure and draining of the company's cash.

Prospective investors in the Red Rock Resorts IPO should be concerned about the potential consequences of the company's plans for a tax receivable agreement (TRA). Under this agreement, Red Rock Resorts, Inc. will be required to pay the pre-IPO owners of Station Holdco LLC a "substantial"[1] amount of cash (equal to 85% of certain tax benefits) as a result of the IPO and subsequent sale of ownership stakes by insiders. TRA payments will not be subject to the approval of outside investors, can negatively affect free cash flow (not EBITDA) and Class A stockholders' equity, and will be in addition to quarterly tax distributions payable to the pre-IPO owners.[2]

- **Tax receivable agreements are criticized by experts.** TRAs found in IPOs are frequently criticized for benefiting pre-IPO owners at the expense of the public company and outside shareholders. Moreover, TRAs have been promoted by corporate tax firms as a way to monetize tax attributes *for the pre-IPO owners* during an IPO even though such agreements "are not fully understood by public stockholders."[3]

- **What are the terms of the Red Rock Resorts TRA?** Red Rock Resorts will be required to pay pre-IPO owners a yet-to-be-disclosed, "substantial" amount of money for the tax benefits it realizes from acquiring partnership interests in Station Holdco LLC. The January 14th amended S-1 filing states that the public corporation will pay pre-IPO owners 85% of its tax benefits in cash and keep only 15% for itself. The 15-plus year agreement will not be based on continued ownership by the pre-IPO owners and the Fertittas, who will be the controlling shareholders after the IPO, can cause Red Rock Resorts to accelerate the TRA payments at any moment.

- **TRA payment liabilities can increase after the IPO.** An examination of other companies which have gone public with similar TRAs reveals that estimates made at the time of an IPO commonly increase, exceeding the company's IPO proceeds and annual EBITDA. Red Rock Resorts admits its calculations will be "imprecise" and there is no guarantee the company will realize the tax benefits it is paying to insiders. Furthermore, the company discloses that payments made under the agreement will spur additional payments to insiders and may significantly impact the liquidity of the company.

- **Investors deserve more information and protection.** Red Rock Resorts should provide justification for the 85%-15% split, clear estimates of the annual and lump-sum payments to the pre-IPO owners, and disclosures regarding how the payments will affect free cash flow and capital expenditures. Furthermore, prospective investors should demand a cap on Red Rock Resorts' TRA payments to the Fertittas and other pre-IPO owners to avoid potentially outsized or even unlimited exposure in the future.

The Problems of IPOs with TRAs

One of the problems that TRAs pose for outside investors is that the payments are typically not accounted for in their EBITDA-based valuation of a company. According to Deborah L. Paul and Michael Sabbah from the law firm Wachtell, Lipton, Rosen & Katz:

> It has become conventional wisdom that public stockholders tend not to assign full value to the tax attributes of a corporation. Similarly, **public stockholders apparently do not discount the value of a corporation to account fully for future payments to be made under a TRA**. A possible explanation for this is that the tax attributes, and especially the terms of TRAs, are not fully understood by public stockholders, even though these agreements are publicly disclosed. **In addition, public company valuations generally are based on EBITDA** (earnings before interest, taxes, depreciation and amortization) **which disregards tax attributes because EBITDA does not take account of taxes**. Another reason may be that tax attributes are difficult to value accurately, because any valuation would rely on income projections and other assumptions about the corporation's ability to use the tax attributes in the future [emphasis added].[4]

Although TRA payments, which are based on estimated changes in a company's tax obligations, do not affect EBITDA, the payments do affect the free cash flow of a company. As noted financial blogger Yves Smith writes:

> Perversely, because the TRA is booked as a liability to the IPO company, payments on the TRA are not treated as an expense, but as a debt payment, so they reduce the company's economic value (its free cash flow, which is the bedrock measure of what a company is worth) without hitting its income statement.[5]

And TRAs can become a significant liability for companies. Smith continues:

> They pull out a substantial amount of cash flow. They have a typical term of 15 years but can be extended because the underlying tax goodies that the private equity firm is trying to exploit can last as long at the life of the company itself. Thus the TRA has the effect of levering up the IPO company in a way that most investors don't appreciate. Levered companies are more fragile than unlevered companies. The IPO company has less money to make investments or withstand adverse developments.[6]

Not only are TRA payments a liability, but the complexity of these agreements demand extensive accounting and auditing costs for a public company. The CFO of a company that recently paid its way out of a TRA had this to say:

> We are pleased to be able to settle our obligations under the TRA which will allow us to take full advantage of the step up in tax basis related to our IPO transactions. **Ending the TRA will also significantly reduce the accounting and audit burden associated with this complex agreement.** We see this as an efficient and accretive use of capital at this time, and a good opportunity to further manage our balance sheet liabilities [emphasis added].[7]

TRAs have been described as “underhanded,” “unusually one-sided,” and a “bizarre siphoning off of cash.”[8] According to corporate tax and accounting expert Robert Willens, “it drains money out of the company that could be used for purposes that benefit all shareholders.”[9] In describing IPOs with TRAs, an academic study states:

> These types of IPOs—deals supercharged with post-sale payments—were unseen and unheard of prior to 1993. Today, they involve the transfer of billions of dollars back to the original owners on an annual basis, and they have become more than a little controversial.[10]

Understanding the Red Rock Resorts IPO Tax Receivable Agreement

The expected tax benefits underpinning the TRA stems from the Up-C structure of the Red Rock Resorts IPO. An Up-C IPO preserves a company’s LLC structure (and its tax advantages for the LLC members) while creating a new C corporation that acquires a minority stake in the LLC with proceeds from selling its stock to public investors.[11] (See this presentation and article for more information about Up-C IPOs.)

With the Up-C structure, Red Rock Resorts will increase its tax basis in Station Holdco LLC as (1) it purchases LLC Units from pre-IPO owners and (2) pre-IPO owners of LLC Units exchange their interests and Class B shares for Class A shares. With an increased tax basis, Red Rock Resorts will realize increased depreciation and amortization deductions as well as other tax benefits.

> As described in "The Reorganization of our Corporate Structure," we intend to use a portion of the proceeds from this Offering to purchase LLC Units from certain of our existing owners. In addition, the existing holders of the LLC Units may (subject to the terms of the exchange agreement) exchange their LLC Units, together with all outstanding shares of Class B Common Stock, for shares of our Class A Common Stock on a one-for-one basis or, at our election, for cash. As a result of this initial purchase and any subsequent exchanges, Red Rock will become entitled to a proportionate share of the existing tax basis of the assets of Station Holdco. In addition, Station Holdco intends to make an election under Section 754 of the Code effective for the first taxable year in which an exchange or purchase of LLC Units occurs and all future years, which may result in increases to the tax basis of the assets of Station Holdco. These increases in tax basis are expected to increase our depreciation and amortization deductions and create other tax benefits and therefore may reduce the amount of tax that Red Rock would otherwise be required to pay in the future. These increases in tax basis may also decrease gains (or increase losses) on future dispositions of certain assets.[12]

Red Rock Resorts is expected to see cash “savings” as a result of having a greater depreciation and amortization expense, which means less income and thus less taxes. The TRA will require Red Rock Resorts to pay pre-IPO owners 85% of these “savings” compared to the amount of income taxes it would otherwise have to pay, and the remaining 15% will be “kept” by Red Rock Resorts and its stockholders. Such payments will likely cost the company millions of dollars in cash per

year, continue for at least 15 years, and decline in amount thereafter.[13] It is not explained in the IPO prospectus why Red Rock Resorts and its stockholders should not retain greater than 15%, if not all, of these tax benefits. As is typical with such TRAs, the 85%-15% split seems completely "arbitrary."[14]

In addition, IPO TRAs do not align the interests of the pre-IPO owners with the public company because they are commonly structured to pay pre-IPO owners regardless of how much equity they continue to hold in the company. In the case of Red Rock Resorts:

These tax benefit payments are not necessarily conditioned upon one or more of the existing owners maintaining a continued ownership interest in either Station Holdco or Red Rock.[15]

Therefore, even if the pre-IPO owners of the company sell all of their equity, Red Rock Resorts will still be required to pay them for the length of the agreement.

Red Rock Resorts does have the right of early termination under the TRA and a change of control will also lead to a termination of the agreement. However, terminating the agreement will cause the company to make a lump-sum payment to pre-IPO owners that is "equal to the present value of future payments."[16] Red Rock Resorts will be a controlled company after the IPO, and the Fertittas will hold a majority of the voting power in Red Rock Resorts through their super-voting Class B shares and currently hold the most equity in Station Holdco. The right of Red Rock Resorts to terminate the TRA early could be seen as the right of the Fertittas to cause the company to make a large lump-sum payment to themselves at any time and thereby allow themselves to immediately extract millions of dollars from the publicly traded company.

The Potential Swelling Cost of TRAs

The cost of TRA payments are based on a number of factors. According to Red Rock Resorts' prospectus[17], these factors include:

- The timing of purchases or exchanges
- The price of shares of our Class A Common Stock at the time of the purchase or exchange
- The extent to which such purchases or exchanges are taxable
- The amount and timing of our income
- Tax rates in effect at the time of the agreement

Estimates for TRA payments can therefore change based on these and other factors and may swell beyond the company's initial estimates. As a result, TRA payments can increase considerably from the initial estimates disclosed in a company's IPO prospectus and become a significant liability item on the balance sheet. (See Table 1.)

PBF Energy Inc. completed its IPO with a TRA on December 18, 2012. Between December 3, 2012 and November 11, 2015, the estimate for its TRA payments increased by 7.6 times the initial figure – from $96.8 million to $735.4 million. The most recent TRA payments estimate is 3 times the company's TTM 3Q15 EBITDA and 1.3 times the IPO proceeds.

Shake Shack Inc. completed its IPO with a TRA on February 4, 2015. Between January 28, 2015 and August 10, 2015, the estimate for TRA payments grew to four times the original figure – from $216.1 million to $884.6 million. The most recent TRA estimate is 50 times the company's TTM 3Q15 EBITDA and 7.9 times the IPO proceeds.

GoDaddy Inc. completed its IPO with a TRA on April 7, 2015. In seven months the TRA payments estimate grew by $300 million. The most recent TRA estimate is 15 times the company's TTM 3Q15 EBITDA 3.5 times the IPO proceeds.

Table 1: TRA Estimates Increase after IPO

Company	Pre-IPO TRA Estimate	Post-IPO TRA Estimate
PBF Energy Inc.	$96.8 million	$735.4 million (35 months after IPO)
Shake Shack Inc.	$216.1 million	$884.6 million (6 months after IPO)
GoDaddy Inc.	$1.4 billion	$1.7 billion (7 months after IPO

In order to avoid the swelling cost of TRAs, some companies have negotiated a cap on TRA payments. For example, when Genworth Financial entered into a TRA with General Electric following their separation, the companies agreed on a maximum aggregate payment to GE of $640 million. As described in Genworth's March 1, 2005 10-K filing:

> We are obligated, pursuant to our Tax Matters Agreement with GE, to pay to GE, on an after-tax basis and subject to a cap of $640 million, 80% of the amount of tax we are projected to save for each tax period as a result of these increased tax benefits. We have recorded the $389 million present value of this obligation to GE as a liability on our statement of financial position. These amounts reflect considered judgments and assessments as to the underlying assumptions and facts. However, under the Tax Matters Agreement, with certain exceptions relating to specified contingent benefits and excluding interest on payments we defer, our total payments to GE will not exceed a nominal amount of $640 million.[18]

To put that number in context, $640 million is 35% of Genworth's 2004 EBITDA.

Prospective investors in the Red Rock Resorts IPO should demand a cap on TRA payments to prevent potentially unlimited exposure to this significant liability that can negatively affect free cash flow and stockholder equity.

More Risks Related to the TRA

In addition to the questionable structure and substantial amount of these payments, there are other risks the TRA poses to outside investors. For instance, the company admits that its calculation of these benefits will be "by its nature imprecise."[19] Furthermore, the company states:

> No assurance can be given that the IRS will agree with the allocation of value among our assets or that sufficient subsequent payments under the tax receivable agreement will be available to offset prior payments for disallowed benefits. As a result, in certain circumstances, payments could be made under the tax receivable agreement in excess of the benefit that we actually realize in respect of the increases in tax basis resulting from our purchases or exchanges of LLC Units and certain other tax benefits related to our entering into the tax receivable agreement.[20]

In other words, if the IRS does not agree with how Red Rock Resorts estimates its tax benefits under the TRA and the company does not realize any actual cash "savings" on its tax bill, it will still have to pay 85% of those estimates *in cash* to the pre-IPO owners. In the case that TRA payments are made to pre-IPO owners in excess of the actual tax benefits Red Rock Resorts realizes, the company admits that it "will not be reimbursed"[21] for these payments although it can offset them against future payments—if there *are* any future payments.

The company also discloses that payments under the TRA will lead to additional payments to insiders. This is due to the fact that the TRA payments are structured as part of the original sale of the partnership interests and, therefore, further increase the company's tax basis in the partnership.

> Furthermore, payments under the tax receivable agreement will give rise to additional tax benefits and therefore additional payments under the tax receivable agreement itself.[22]

In other words, making the TRA cash payments will in fact lead to an increase in TRA liabilities on the part of Red Rock Resorts.

Additionally, Red Rock Resorts acknowledges that the TRA could significantly impact the liquidity of the company.

> We will be required to pay our existing owners for certain tax benefits we may claim arising in connection with this Offering and related transactions, and the amounts we may pay could be substantial. [23]
>
> In certain cases, payments under the tax receivable agreement may be accelerated and/or significantly exceed the actual benefits, if any, we realize in respect of the tax attributes subject to the tax receivable agreement [...] **In these situations, our obligations under the tax receivable agreement could have a substantial negative impact on our liquidity, and there can be no assurance that we will be able to finance our obligations under the tax receivable agreement.** In addition, these obligations could have the effect of delaying, deferring or preventing certain mergers, asset sales, other forms of business combinations or other changes of control, in particular in circumstances where our Principal Equityholders have interests that differ from those of other shareholders. Because our Principal Equityholders will retain a controlling ownership interest following the Offering, we expect that our Principal Equityholders will control the outcome of votes on all matters requiring approval by our stockholders. Accordingly,

> actions that affect such obligations under the tax receivable agreement may be taken even if other stockholders oppose them [emphasis added].[24]

Given the multiple risks associated with the TRA, including the imprecise nature of TRA payment calculations and, if there is an error, that such payments will not be reimbursed, outside investors should have a say in the tax advisory firm that is charged to determine the amount of these payments. According to the Tax Receivable Agreement that was filed with the Jan. 14, 2016 S-1/A, the board of Red Rock Resorts, which will be a Fertitta-controlled company, will decide which tax firm is appointed to handle these payments to the Fertittas and other pre-IPO owners.[25] Prospective investors should demand a different arrangement that gives outside shareholders the right to appoint which tax advisory firm is used to determine the TRA payments and the right to independent arbitration should there be any disputes over the size of the TRA payments.

Investors Need Protection

Prospective investors should insist on further clarification and protections surrounding the TRA before they invest in the Red Rock Resorts IPO. Specifically, investors should seek:

- An explanation of the 85%-15% split and justification for why the pre-IPO owners deserve the bulk of the tax benefits due to the public company.
- Clear estimates of the annual payments to the pre-IPO owners under the TRA and the present value of all future payments should the TRA be accelerated.
- Disclosure of how the TRA payments will impact cash flow and capital expenditures.
- The ability by outside shareholders to select a tax advisory firm that is neutral and has no material relationship with the company or its pre-IPO owners.
- The right of outside shareholders to independent arbitration should there be disputes over the size of the TRA payments.
- A cap on payments in order to protect their investment against the potential unlimited exposure and draining of the company's cash under the TRA.

Notes

[1] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 155. The company has not yet disclosed how many millions of dollars it will pay to existing owners through this deal.

[2] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 37.

[3] Paul, Deborah L. and Michael Sabbah 2013. Understanding Tax Receivable Agreements. Practical Law, June 2013. P. 75.

[4] Paul, Deborah L. and Michael Sabbah 2013. Understanding Tax Receivable Agreements. Practical Law, June 2013. P. 75.

[5] Smith, Yves. Another Private Equity Scam – Tax Receivable Agreements. Naked Capitalism. August 3, 2015. http://www.nakedcapitalism.com/2015/08/another-private-equity-scam-tax-receivable-agreements.html

[6] Smith, Yves. Another Private Equity Scam – Tax Receivable Agreements. Naked Capitalism. August 3, 2015. http://www.nakedcapitalism.com/2015/08/another-private-equity-scam-tax-receivable-agreements.html

[7] Cloud Peak Energy. Cloud Peak Energy Announces Termination of Tax Receivable Agreement with Rio Tinto. Press Release. August 20, 2014. http://investor.cloudpeakenergy.com/press-release/corporate/cloud-peak-energy-announces-termination-tax-receivable-agreement-rio-tinto

[8] *Cited from* Fleischer, Victor and Nancy Staudt 2013. The Supercharged IPO. USC Gould School of Law. Center in Law, Economics and Organization. Research Paper Series No. C13-6. Pp. 1, 4.

[9] Browning, Lynnley. Squeezing Out Cash Long After the I.P.O. New York Times. March 13, 2013. http://dealbook.nytimes.com/2013/03/13/private-equity-squeezes-out-cash-long-after-its-exit/?_r=0
[10] Victor and Nancy Staudt 2013. The Supercharged IPO. USC Gould School of Law. Center in Law, Economics and Organization. Research Paper Series No. C13-6. Pp. 3-4.
[11] Bilsky, Jeffrey N., and Avi D. Goodman. An Alternate Route to an IPO: The Up-C Partnership Structure. The Tax Adviser. November 1, 2015. http://www.thetaxadviser.com/issues/2015/nov/an-alternate-route-to-ipo-the-up-c-partnership-structure.html
[12] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 154.
[13] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. Pp. 154-155.
[14] Paul, Deborah L. and Michael Sabbah 2013. Understanding Tax Receivable Agreements. Practical Law, June 2013. Pp. 77-78
[15] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 66.
[16] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 37.
[17] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. Pp. 154-155.
[18] Genworth Financial, Inc. SEC Form 10-K. March 1, 2005. P. 180.
[19] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 154.
[20] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 156.
[21] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 156.
[22] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. Pp. 75-76.
[23] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 36.
[24] Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016. P. 37.
[25] Tax Receivable Agreement among Red Rock Resorts, Inc. and Station Holdco LLC. P.2. Exhibit to Red Rock Resorts, Inc. SEC Form S-1/A. January 14, 2016.