Red Rock Resorts/Station Casinos

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A Report by UNITE HERE

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Questions about the Fertitta Entertainment Acquisition

A key feature of the Red Rock Resorts IPO is the use of proceeds, plus additional debt, to acquire Fertitta Entertainment for $460 million in a related-party transaction. Investors should ask the company how it arrived at and agreed to this price and why Red Rock is letting insiders cash out substantial funds through the IPO instead of reducing debt or funding growth.

1. Red Rock is buying an insiders' company at a high valuation to internalize management. Fertitta Entertainment LLC does not appear to have any other revenue other than the management fees it receives from Station Casinos. It was paid $52.7 million in management fees by Station Casinos in 2015 and had $72.8 million of debt outstanding at the end of 2015. As explained by Red Rock management during the special meeting of Nevada gaming regulators to approve the IPO on Jan. 21, the Fertitta Entertainment acquisition is to be understood as the internalization of an external manager. Existing executives and corporate personnel of Station Casinos, who are currently employees of Fertitta Entertainment, will become directly employed by Red Rock after the deal.

Here is some perspective on the $460-million price tag. It equals:

- **93% of the estimated IPO net proceeds of $495.9 million** (assuming the mid-point of the offering price range and that the underwriters do not exercise their options to purchase additional shares)
- **20% of the IPO valuation of Station Casinos' equity of $2.26 billion** (with the same assumptions as above)
- **8.7 times Fertitta Entertainment's 2015 management fee revenue from Station Casinos**
- **31 times Fertitta Entertainment's 2015 pro forma EBITDA of $14.8 million** (which we calculated by comparing the financials of the consolidated Station Holdco LLC and Station Casinos)

How does this $460-million "internalization fee" compare to those commonly found in REIT internalization transactions? A September 2014, study of REIT internalization fees by Sherry Cefali and Nick Tarditti of Duff & Phelps shows the range of REIT external manager valuations from 1997 to 2013.

	REIT internalization fee from 1997 to 2013
As % of acquirer equity	2.7% - 10%
AS % of manager's TTM EBITDA	2.9x – 14.0x

The $460-million Fertitta Entertainment “internalization fee” is much higher compared to these valuations.

Also, the Fertitta Entertainment “internalization fee” will be paid entirely in cash instead of equity or a combination of cash and equity. Some REITs have internalized external managers with no fee.

2. Termination fee provisions in certain Fertitta Entertainment management agreements
According to the Fertitta Entertainment management agreement covering 13 of the 19 Station Casinos properties, termination of the agreement upon sale of the managed properties to a third party would only cost Station Casinos a fee equal to the trailing-twelve-month management fee. See *Exhibit “D” Financial Terms* of this management agreement, which can be found as Exhibit 10.21 of Station Casinos LLC’s 10-K, filed 3/10/15:

> The “Termination Fee” shall be, upon a Third Party Sale with respect to all Managed Properties, an amount equal to the sum of the Management Fees for the trailing twelve (12) month period prior to the Termination (“TTMMF”) if the Third Party Sale occurs prior to the expiration of the fifth (5th) Full Fiscal Year of the Term [12/31/2016].

And the termination fee upon a third-party property sale declines after the fifth year of the contract and becomes zero at the start of the twentieth year.

If the termination fee for outright sale to third parties, where the management agreement is terminated and existing management is replaced, is to equal only 1x TTM management fee for a majority of Station Casinos properties, then the non-insider cost for acquiring Fertitta Entertainment should be closer to $52 million, not $460 million.

3. What company management told Nevada gaming regulators about the Fertitta Entertainment deal
Even though the company’s IPO prospectus filings do not describe any specific financial benefits of the Fertitta Entertainment acquisition, Red Rock management explained the valuation basis of the Fertitta Entertainment deal when they presented during the special meeting of the Nevada Gaming Control Board meeting to approve the IPO. CFO Marc Falcone said:

> With the transaction and the acquisition of Fertitta Entertainment, we actually improve, EBITDA will go up by *$34 million, approximately*. So we are basically taking the management fees that were historically paid to Fertitta Entertainment, those now will remain within Red Rock Resorts, Inc., and Station Casinos LLC. We are also adding back some expenses that related to salaries and wages for the employees that are currently employed at the Fertitta Entertainment level that will now be employed at the Station Casinos LLC level [emphasis added].[1]

That is, the company believes that internalizing Fertitta Entertainment would lead to incremental annual EBITDA of $34 million because that's the amount it would "save" by (1) not paying out management fees ($52 million in 2015) anymore but (2) paying corporate expenses covering its executives and corporate employees directly, who are currently employed and paid by Fertitta Entertainment. If $34 million incremental EBITDA is the basis for the $460 million price, a 13.5x multiple was used. It thus appears the company has agreed to transfer 13.5 years of *potential* EBITDA "savings" as an immediate lump-sum cash payment to the owners of Fertitta Entertainment as part of the IPO.

Mr. Falcone's statement implies that the company is expecting to pay only $18 million a year in corporate expenses going forward ($52 million minus $34 million). Is $18 million in corporate expenses a realistic number for a company the size of Red Rock/Station Casinos?

Let's consider what Station Casinos used to do when it was a publicly-traded company. In the last three full years when it was a publicly-traded company before the disastrous insider-led leveraged buyout of 2007, the company paid on average about 4.9% of its net revenues out as corporate expenses.

($ millions)	**2004**	**2005**	**2006**
Net revenues	$986.7	$1108.8	$1339.0
Corporate expenses	$47.2	$57.6	$63.1
Corporate expenses as % of net revenues	4.8%	5.2%	4.7%

In 2015, Station Casinos had net revenues of $1.35 billion. If it had paid its own corporate expenses at a level like it used to during the three-period listed above, it would have spent $61 million in corporate expenses. We believe it would be unrealistic to expect to pay only $18 million in corporate expenses after Red Rock internalizes Fertitta Entertainment.

We believe prospective investors should ask Red Rock management the following questions:

- **Is Red Rock projecting $34 million of incremental annual EBITDA and therefore only $18 million in annual corporate expenses on a going-forward basis after buying Fertitta Entertainment and internalizing management?**
- **If yes, does that projection include potential equity-based compensation expenses?**
- **And what is the plan to keep corporate expenses at $18 million a year for 13.5 years?**

4. Questions about the financial statements of Fertitta Entertainment and Red Rock

Another concern investors should be aware of is how the company accounts for equity-based compensation. According to section 3.08 of the disclosure schedule of the execution copy of the Fertitta Entertainment purchase agreement (filed as Exhibit 10.10 in Red Rock's 2/12/16 S-1/A):

> With respect to [Fertitta Entertainment LLC's] consolidated financial statements for the years ended December 31, 2012, 2013 and 2014 and for the six months ended June 30,

> 2015, the Company did not record share-based compensation expense associated with equity incentives issued to current and former executives of the Company from FI Station Investor LLC. FI Station Investor LLC is an entity that is owned by the parent entities of the Company. Pursuant to GAAP, this non-cash share-based compensation is required to be recorded as a component of the Company's statement of operations since these executives were employees of the Company and FI Station Investor LLC is a common-controlled entity of the Company's equity holders. The Company's auditor, Ernst & Young LLP, has determined that each of the foregoing financial statements would require to be restated and has withdrawn its opinions for each audit period that are dated March 25, 2015, May 14, 2014, April 16, 2013 and May 15, 2012, respectively.

This disclosure should lead investors to ask whether Station Casinos has an accurate handle on historical, current and projected costs of equity-based compensation, which could be an expensive component of cost for any company. (We have sent a letter to the SEC asking some other questions based on this disclosure, too.)

In the end, investors should ask: Why is Red Rock letting insiders cash out substantial funds through the IPO instead of reducing debt or funding growth?

Red Rock is not planning on keeping $460 million of cash in the company's coffers, funds which could be used to grow the company through acquisitions or new development, or pay down the company's $2.2 billion of long-term debt. If the Fertittas are confident in the growth prospects of Station Casinos, why aren't they taking further equity in the company instead of cashing out substantial sums through this IPO?

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[1] Transcript, special meeting of the Gaming Control Board, 1/21/16, pp.32-33. Transcripts of all Gaming Control Board and Nevada Gaming Commission public meetings can be ordered from Sunshine Litigation Services at 775-323-3411.