Report on Red Rock's Independent Directors:

Why it is Necessary to Withhold Your Vote

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> *On a board, all directors have equal responsibility. But some directors fail to accept that responsibility. They concur with the thinking of the chairman and CEO, and thereby are transferring their power and forgoing their duty as directors.* – Bob Tricker, "Corporate Governance"

EXECUTIVE SUMMARY

In this report we argue that it is necessary for Red Rock Resorts' shareholders to withhold votes from the company's three independent directors – James E. Nave, D.V.M., Robert E. Lewis, and Robert A. Cashell, Jr. – on their proxies for the company's upcoming July 6, 2017 annual stockholders meeting. These long-serving directors have failed to advocate for the sunsetting of the company's myriad of poor corporate governance features since its IPO last year, and they have not acted to prevent the enrichment of company insiders and related parties. We believe it is essential to send an unambiguous message to management that investors expect a higher standard of corporate governance at a publicly-traded company, especially now that outside shareholders own a majority of the economic interest in the company.

Red Rock Resorts, Inc. (NASDAQ: RRR; *hereafter* "Red Rock") went public in April 2016, using IPO proceeds to purchase economic interests in Station Holdco LLC, the holding company for Station Casinos LLC, which owns and operates 10 casino hotels and 10 small neighborhood casinos in Las Vegas, Nevada and manages a tribal casino in Michigan and a tribal casino in California.

In taking the company public, Red Rock's board of directors implemented several antitakeover measures, including a dual-class ownership structure with 10:1 super voting stock for insiders, supermajority approval requirements to amend certain aspects of the certificate of incorporation and bylaws, as well as limitations on actions by written consent and special meetings of stockholders, an insider's exemption from a Delaware antitakeover statute, and a tax receivable agreement poison pill.

Red Rock's three independent directors are the sole members of its Nominating and Corporate Governance Committee, which is responsible for monitoring the company's governance matters. As the company is not proposing to sunset the pre-IPO anti-takeover devices, their persistence is a strong sign that Red Rock's independent directors do not value the interests and rights of outside shareholders.

Furthermore, Red Rock's independent directors have a history of approving transactions that are not in the best interest of the company or its outside shareholders, including excessive equity compensation, the Fertitta Entertainment internalization transaction, the tax receivable agreement, income tax distributions to Station Holdco LLC Unit holders, and, most recently, a debt-financed $120-million purchase of two related-party land leases.

Given Red Rock's dual-class share structure, there is little chance that outside shareholders can effect meaningful reform in corporate governance through shareholder proposals or proxy contests. Nevertheless, investors can send a clear and strong signal to the company that things need to change by withholding their votes from the three putatively independent directors.

For these reasons, we encourage Red Rock's Class A shareholders to withhold their votes from the elections from Directors Nave, Lewis, and Cashell at the company's upcoming annual meeting of stockholders.

CORPORATE GOVERNANCE CONCERNS

Red Rock's independent directors – Dr. Nave, Mr. Lewis, and Mr. Cashell – comprise the Nominating and Corporate Governance Committee. According to the company's SEC filings, one of the primary responsibilities of the committee is to:

> Monitor our corporate governance principles and practices and make recommendations to our board of directors regarding governance matters, including the certificate of incorporation, our bylaws and charters of our committees.[1]

Despite this responsibility, Red Rock's independent directors did not prevent major corporate governance issues for outside investors in the newly public company. As a result, Red Rock has some of the worst corporate governance, catching the eye of the Council of Institutional Investors (CII) who issued this alert leading up to the IPO:

> Red Rock Resorts, a Las Vegas casino company pursuing an IPO, provides a perfect example of why CII's Policies Committee and board of directors approved a statement that calls on young companies with corporate governance structures that insulate management from shareholders to sunset these structures within a limited time period.[2]

Leading proxy advisory firm Institutional Shareholder Services as well as the Investor Stewardship Group (ISG) also recommend sunset provisions for multi-class capital structures with unequal voting rights.[3,4] Some significant holders of Red Rock's Class A shares – including BlackRock, JP Morgan, T. Rowe Price, and the Vanguard Group – are members of the Investor Stewardship Group whose second principle of corporate governance for US listed companies states that "shareholders should be entitled to voting rights in proportion to their economic interest." The ISG principle continues:

> Boards of companies that already have dual or multiple class share structures are expected to review these structures on a regular basis or as company circumstances change, and establish mechanisms to end or phase out controlling structures at the appropriate time, while minimizing costs to shareholders.[5]

Contrary to the recommendation of corporate governance experts, institutional investors, and asset managers, the company has not indicated if it plans to sunset any of these provisions or put them to a vote of Class A shareholders.

Antitakeover Devices

Red Rock's anti-shareholder, antitakeover corporate governance includes:

- ✓ Dual-class equity structure with 10:1 super voting stock for the controlling, Fertitta family insiders.
- ✓ Supermajority (2/3) vote requirements to change sections of the company's certificate of incorporation and bylaws when the company is no longer controlled.
- ✓ Limitations on stockholder action by written consent.
- ✓ Limitations on special meetings of stockholders.
- ✓ Fertitta family exemption from a Delaware antitakeover statute, while upholding the statute for all other "interested stockholders."
- ✓ Board's right to issue preferred stock without shareholder approval.
- ✓ Poison pill connected to the Tax Receivable Agreement with pre-IPO owners.

Studies shows dual-class shares have no effect on long-term company performance and pose increased costs. A new CII study of 1,762 U.S.-incorporated Russell 3000 companies from 2007-2015 contradicts the claim that multi-class ownership structures with unequal voting rights allow visionary founders to create long-term value. According to CII:

> We conclude multi-class equity, measured by the percentage of the company's vote controlled by holders of superior-voting shares, does not affect ROIC, positively or negatively. Our conclusion supports skepticism that multi-class equity structures are necessary for managers to deliver long-term performance.[6]

In addition, Bebchuk and Kastiel of Harvard's Program on Corporate Governance examined the costs and governance risks of IPOs with long-term dual-class structures. The authors raise concerns surrounding low equity holdings and insider entrenchment, find that potential benefits of dual-class structures tend to recede and costs tend to rise as time passes from the IPO, and encourage models to sunset such structures.[7]

RRR's poison pill liability for tax receivable agreement (TRA) has increased 8x since IPO to over one-quarter billion dollars. The TRA requires Red Rock to pay Station Holdco LLC Unit holders 85% of the tax benefits it receives through its Up-C corporate structure.[8] Over the past year, RRR's liabilities to pre-IPO owners pursuant to the TRA has swelled from \$28.1 million to \$258.5 million – an 8.2x increase.[9,10] RRR expects annual payments will range from \$1 million to \$15 million over the next 40 years, with \$21.6 million payable to the Fertitta family and \$193.3 million to Deutsche Bank subsidiary German American Capital Corporation (GACC).[11] The TRA liability can continue to increase as pre-IPO owners sell their equity stakes and as payments that are made under the TRA, paradoxically, increase TRA payment liabilities.[12] Most importantly, the quarter billion in liability payments can become accelerated, due, and payable in the event of a change in control or at the election of the company, acting as a significant takeover deterrent.[13]

The $258.5 million TRA liability is equal to:

- 70% of total Red Rock Resorts, Inc. stockholders' equity (as of March 31, 2017).[14]
- 2.8 times net income attributable to Red Rock for 2016 ($92.0 million).[15]

Dual-class shares hinder Red Rock's M&A potential. M&A activity in 2017 looks healthy for the gaming industry**.** With limited opportunities for organic growth due to a maturing market, a slowing RevPAR environment in U.S. lodging, and few, if any, new gaming market opportunities, S&P Ratings expects consolidation to continue in the gaming industry as a strategy to "provide faster growth and economies of scale."[16]

On June 12, 2017, Golden Entertainment, a dominant player in the Las Vegas local tavern market, announced its acquisition of American Casino & Entertainment Properties LLC for $850 million in cash and equity, picking up two Las Vegas locals casinos, a strip property, and a resort in Laughlin at a 35% discount to the $1.3 billion ACEP paid Carl Icahn for the properties in 2007.[17,18] Commenting on the deal, Fitch Ratings senior director Alex Bumazhny said:

> Consolidation in gaming, broadly, has been happening over the past 10-15 years in a bigger sort of way in the regional and Las Vegas Strip side. And in the last years, we're seeing it more rapidly on the locals side as well.[19]

However, an opportunity to expand may fail to materialize due to the presence of dual-class shares on the part of the acquirer. Such was the case with the losing bidder in a recent major merger in the hotel industry. As Crain's Chicago explained, "shares with reduced voting rights make an unattractive buyout currency."[20]

On the other hand, public investors would have virtually no say in the outcome if Red Rock were to become a target. Furthermore, takeover defenses can limit shareholders from realizing value even if an offer presents itself.

On May 1, 2017, regional gaming company Eldorado Resorts (NASDAQ: ERI) completed its acquisition of Isle of Capri Casinos (NASDAQ: ISLE), with ERI offering ISLE shareholders $23.00 in cash or 1.638 shares of ERI stock for each ISLE share.[21] The consideration of $23.00 per share (which was first announced on Monday September 19, 2016) represents a 36% premium over the closing share price of Isle of Capri on Friday, September 16, 2016 ($16.93).[22,23] The transaction added twelve casino hotels across five states to Eldorado's portfolio, with Eldorado now holding 19 properties in 10 states, increasing its geographic diversity and providing expected cost synergies of $35 million over the next year.[24,25]

Analysts from Wells Fargo, J.P. Morgan, Deutsche Bank, and Moody's have all pointed to Red Rock's "limited geographic diversity"[26] and that it is "highly dependent on the Las Vegas Locals Market"[27] as one of the company's primary investment risks.[28,29] An M&A opportunity to expand into other states may be well-received by Red Rock's investors due to the company's dependence on the saturated and stagnant Las Vegas Locals Market. The company's bevy of anti-takeover devices – approved by the independent directors who are not recommending their removal – make it unlikely such an offer to purchase Red Rock at a premium would even be presented.

BOARD OF DIRECTORS

Five directors currently sit on Red Rock's Board: Frank J. Fertitta III, Lorenzo J. Fertitta, James E. Nave, D.V.M., Robert E. Lewis, and Robert A. Cashell, Jr. Frank Fertitta, CEO, serves as the Chairman, Lorenzo Fertitta is the Vice Chairman of the Board, and Dr. Nave serves as the lead independent director.

Red Rock classifies Dr. Nave, Mr. Lewis, and Mr. Cashell as independent directors according to NASDAQ listing standards. After a review of past actions – or lack thereof – on certain insider and related-party transactions, we question their ability to be responsive to and protective of the interests of outside shareholders.

Independence Evaluation

Red Rock recently made a $120-million related-party purchase of two long-term land leases. The transaction involved purchasing KB Enterprises and Texas Gambling Hall & Hotel, Inc., companies owned by the Frank J. Fertitta and Victoria K. Fertitta Revocable Trust, which owned 27 acres beneath Boulder Station and 47 acres beneath Texas Station. The $120-million price tag equates to $1.6 million per acre, which is overpriced when evaluated using a sales comparison approach (Table 1). Notably, the price per acre was 16 times the price per acre of an adjoining parcel to Boulder Station that was sold by a subsidiary of Station Casinos to Precedent Properties LLC in December 2016.

Table 1: Sales Comparison

	Related Lessor Purchase (4/2017)	The Orleans	Raiders' NFL Stadium	Boulder Station parcel (12/2016)
APN	16107702014, 13919502001, 13919602001	16219402001, 16219302001	16229302001, 16229302003, 16229302004, 16229401017	16107702001
Seller	KB Enterprises; Texas Gambling Hall & Hotel Inc.	The Tiberti Company, LLC	Nevada Land Group LLC	NP Horizon Park LLC (Station Casinos)
Buyer	Station Casinos	Coast Hotels & Casinos Inc.	LV Stadium Company LLC	Precedent Properties LLC
Zoning	H-1, C-2	H-1	H-1	R-E
Sale Date	April 27, 2017	March 29, 2017	May 1, 2017	Dec 30, 2016
Sale Price	$120 million	$43.0 million	$77.5 million	$800,000
Acres	74.6 acres	73.1 acres	62.6 acres	8.0 acres
Price/Acre	**$1.62 million**	**$588,235**	**$1.24 million**	**$100,000**

The timing of the deal is somewhat puzzling, especially since the company had the option to purchase the Boulder Station parcel at fair market value in July 2018 (and the option to purchase the Texas Station parcels at fair market value in April 2030).[30] As [Bloomberg reported](), at least one shareholder thought the purchase price "was on the high side."[31]

Even the company seems to acknowledge that it paid more than fair market value. In its 10-Q filed on May 10, the company states:

> As a result of such acquisition and the termination of the ground leases, the Company expects to recognize a charge in an amount equal to the difference between the aggregate consideration paid by the Company and the acquisition date fair value of the land and residual interests, which charge is expected to have a material impact on its net income and earnings per share for the three and six months ending June 30, 2017.[32]

It is not clear whether the independent directors, who comprise the Audit Committee, reviewed and approved the transaction according to the company's related party transaction policy, whereby:

> The Audit Committee is charged with reviewing all relevant facts and circumstances of a related party transaction, including the commercial reasonableness of the terms, the benefit or perceived benefit, or lack thereof, to us, opportunity costs of alternate transactions, the materiality and character of the related person's direct or indirect interest and the actual or apparent conflict of interest of the related person.[33]

The $460 million Fertitta Entertainment internalization transaction used IPO proceeds plus debt to pay hundreds of millions to insiders. The internalization of Station Casinos' external management company, Fertitta Entertainment, was a bad deal for outside investors.[34] According to Red Rock's March 13, 2017 10-K:

> Of the $460.0 million purchase price, $51.0 million was used to repay amounts outstanding under Fertitta Entertainment's credit facility, $18.7 million was paid to settle Fertitta Entertainment's liability-classified equity awards, and $389.1 million was paid as a deemed distribution to Fertitta Entertainment's equity holders.[35]

The $460 million purchase price is equal to:

- 85% of Red Rock's IPO proceeds of $541 million.[36]
- 20% of the IPO valuation of Station Casinos' equity of $2.26 billion (using the shares outstanding as of 5/31/16 and initial price of $19.50).[37]

Station Casinos paid over $43 million last year to cover its owners' income taxes. While it is not new that Station Casinos LLC is on the hook for related income tax liabilities of its owners, the 10-K filed by Station Casinos for 2016 discloses that the company paid $43.6 million in tax distributions to members of Station Holdco and Fertitta Entertainment.[38] These distributions are in addition to the tax receivable agreement liabilities, in which Red Rock pays 85% of certain tax benefits arising from the corporate structure to pre-IPO owners.

The Tax Receivable Agreement. As part of the 2016 IPO, Red Rock became party to a tax receivable agreement whereby Red Rock (and its shareholders) only receives 15% of certain tax benefits arising from the Up-C IPO and is required to pay the other 85% to pre-IPO owners (including the Fertittas and Deutsche Bank subsidiary German American Capital Corporation). As of April 15, 2017, GACC was owed $193.3 million pursuant to this agreement.[39] Did the independent directors review and approve this agreement after determining it would be in the best interest of the public shareholders of Red Rock?

Nave and Lewis approved "excessive" equity compensation at Station Casinos Inc. despite opposition from outside shareholders. Nave and Lewis were part of the board of former Station Casinos Inc. (Red Rock's public predecessor) when it allowed "excessive" equity compensation to insiders.[40] As far back as 2005, Glass Lewis had called Station Casinos' stock compensation plan "among the most expensive and liberal we have reviewed" and an "excessive transfer of wealth" to insiders."[41] The company added $3.3 billion of new debt in 2006 and 2007, with $990 million of this new debt going toward share buybacks to offset dilution from stock options and restricted shares given to insiders.[42]

WITHHOLD THE VOTE

In taking the company public, Red Rock's board (of which 3/5 are independent directors) approved dual-class ownership structures with super voting stock for Fertitta insiders and other takeover defenses. These defenses can limit shareholders from realizing value and the independent directors have not recommended their removal at the upcoming shareholder meeting. In addition, Red Rock's board has approved numerous transactions and agreements that benefit insiders at the expense of the company and outside shareholders.

Poor corporate governance and questionable transactions that benefit insiders and related parties lead to one simple conclusion: Red Rock's three independent directors do not serve the best interests of the company's outside shareholders.

We encourage Red Rock's outside shareholders to withhold their votes for Dr. Nave, Mr. Lewis, and Mr. Cashell on their proxies for the July 6th annual meeting to send a strong and clear message to management that corporate governance must improve and change must start now.

Notes

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