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A Report by UNITE HERE

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## Who's on the Hook for the Palms?

Red Rock Resorts has set a big ROI target for its Palms Casino Resort. Can they get there? Investors should ask management to set clear markers: who will be held accountable if the post-renovation Palms doesn't generate the kind of ROI management has projected?

Red Rock Resorts has set a big ROI target for its Palms Casino Resort. What started as a \$312.5 million acquisition with \$35 million of EBITDA expected in the first full year of RRR ownership,<sup>1</sup> has now become a \$1 billion project, with a capex budget that has increased to \$690 million over the past year-and-a-half.<sup>2</sup> It's also important to consider the "substantial construction disruption"<sup>3</sup> as well as interest payments on any debt used to fund the redevelopment when evaluating this project. Investors should ask management to set clear markers: who will be held accountable if the post-renovation Palms doesn't generate the kind of ROI management has projected?

### The Palms redevelopment budget increases...again

In February 2018, Red Rock Resorts announced an increase to the Palms redevelopment budget to \$620 million.<sup>4</sup> Subsequently in its 3Q18 financial filing, Red Rock disclosed that the "overall budget" for the Palms redevelopment had increased to \$690 million.<sup>5</sup> When pressed by an analyst for the total redevelopment budget for Palms during the 3Q18 earnings call, Red Rock CFO Stephen Cootey said:

I think we're pretty confident in 690 million at this point, substantially all of the contracts have been awarded. So, probably 95%, let's call it hard [...] And from a return perspective, we just pushed the budget up. That probably impacts return about 50 [basis points], but we're still confident in achieving a low double-digit return on the project.<sup>6</sup>

Together with the purchase price, Red Rock would be into Palms for just over \$1 billion. And with previous ROI guidance of "mid-teens return"<sup>7</sup> minus the 50 bps impact on return from the latest budget hike, investors should expect a 14.5% return on the investment or at the very least a "low double-digit" return of, say, 11.5%. That is, investors should expect the "new" Palms to produce annual EBITDA from \$115 million to \$145 million. Let's take the mid-point of \$130 million as a reasonable expectation based on management's vague guidance (after two years' ramp up).<sup>8</sup> That's a big target to achieve given the low number of hotel rooms at the Palms compared to Strip properties as well as its distance from the Strip.<sup>9</sup> Can they get there?

**Table 1. Palms Investment Updates**

Palms Investment Update	Date Announced	Palms Total Investment	ROI	EBITDA Target
\$312.5 mm (acquisition)	5/10/2016	\$312.5 mm	11.2% (a)	\$35 mm (b)
\$316.7 million (acquisition close)	10/1/2016	\$316.7 mm	11.1% (a)	\$35 mm (b)
\$146 mm	8/8/2017	\$463 mm	15% (c)	\$69 mm
\$485 mm	11/7/17	\$802 mm	15% (d)	\$120 mm
\$620 mm	2/27/18	\$937 mm	15% (e)	\$141 mm
\$690 mm	11/7/18	\$1,007 mm	14.5%/11.5% (f)	\$146 mm/\$115 mm

(a) Calculated from available data

(b) From RRR 5/10/16 press release: "Factoring in anticipated synergies, the Company estimates that the Palms will generate \$35 million in EBITDA during the Company's first full year of ownership, resulting in an implied multiple of 8.8 times EBITDA for the transaction."

(c) RRR CFO Steve Cootey commenting on 8/8/17 earnings call: "mid to low teens return"

(d) RRR CFO Steve Cootey commenting on 11/7/17 earnings call: "we expect to generate a double-digit EBITDA return on our overall investment in the property going to mid-teens return after an appropriate ramping period."

(e) RRR CFO Steve Cootey commenting on 2/27/18 earnings call: "We continue to expect that the total project will generate a mid-teens EBITDA return on our overall investment to property after an appropriate ramping period."

(f) RRR CFO Steve Cootey commenting on 11/7/18 earnings call: "And from a return perspective, we just pushed the budget up. That probably impacts return about 50 bips, but we're still confident in achieving a low double-digit return on the project."

### Palms EBITDA Projection

We used a sum of the parts analysis in order to project the new Palms' pro-forma EBITDA. We assumed that Palms' performance for both gaming and non-gaming revenue will be similar to the performance of casinos within the competitive set of Las Vegas Strip licensees with gaming revenue of \$72 million and over. We estimated gaming revenue by calculating the average annual win per slot and the average annual win per table game (excluding baccarat and card games) using the full-year figures from the Gaming Control Board's (GCB's) December 2018 Gaming Revenue report. We estimated non-gaming revenue by calculating the RevPAR for rooms, food, beverage, and other departments using figures from the GCB's FY 2018 Gaming Abstract. For both sources, we used the aggregate data from Las Vegas Strip licensees with gaming revenues of \$72 million and over.

To determine the final room, slot machine, and table game count for the Palms, we started with counts prior to the redevelopment announcement (as reported by the GCB's nonrestricted count report and in the company's 2017 10-K) and added any units announced as part of the redevelopment phases (i.e. +60 rooms, +300 slot machines, and +16 table games). In total, we expect Palms will have 773 rooms, 1,730 slot machines, and 56 table games.

Finally, we project two scenarios with different EBITDA margins: (1) 30%, which is based on Red Rock's historical EBITDA margins for its Las Vegas operations and (2) 35%, which is considered a bull case should Red Rock streamline its operations at the Palms.<sup>10</sup>

**Table 2. Palms EBITDA Projections<sup>11,12</sup>**

<b>Palms Pro-Forma</b>	<b>30% EBITDA Margin (Red Rock Average 1Q16-4Q18)</b>	<b>35% EBITDA Margin</b>
Slot Machines	1,730	1,730
Annual Win Per Slot (2018)	\$97,231	\$97,231
Slot Revenues (millions)	\$168.2	\$168.2
Table Games	56	56
Annual Win Per Table Game (2018) (ex-baccarat, ex-card games)	\$936,949	\$936,949
Table Game Revenues (millions)	\$52.5	\$52.5
<b>Total Gaming Revenues (millions)</b>	<b>\$220.7</b>	<b>\$220.7</b>
Days	365	365
Rooms	773	773
Room RevPAR (FY 2018)	\$168.32	\$168.32
Total Rooms Revenues (millions)	\$47.5	\$47.5
Food RevPAR (FY 2018)	\$95.83	\$95.83
Total Food Revenues (millions)	\$27.0	\$27.0
Beverage RevPAR (FY 2018)	\$45.36	\$45.36
Total Beverage Revenues (millions)	\$12.8	\$12.8
Other RevPAR (FY 2018)	\$94.06	\$94.06
Total Other Revenues (millions)	\$26.5	\$26.5
<b>Total Non-Gaming Revenues (millions)</b>	<b>\$113.8</b>	<b>\$113.8</b>
<b>Total Revenues (millions)</b>	<b>\$334.5</b>	<b>\$334.5</b>
<b>EBITDA Margin</b>	<b>30%</b>	<b>35%</b>
<b>EBITDA (millions)</b>	<b>\$100</b>	<b>\$117</b>
Total Investment (millions)	\$1,007	\$1,007
<b>ROI</b>	<b>9.9%</b>	<b>11.6%</b>

Using Las Vegas Strip fundamentals for gaming win and departmental RevPARs, we find that Red Rock has a decent chance of reaching \$100 million in EBITDA at the Palms if it can produce an EBITDA margin of 30% (as it has on average in its Las Vegas Operations from 1Q16 to 4Q18). However, \$100 million in annual EBITDA remains \$30 million (or 23%) below the \$130 million we think management guidance currently is. And \$100 million of EBITDA would represent an ROI of just under 10%.

Should Red Rock be able to achieve an EBITDA margin of 35% at the Palms, the resulting annual EBITDA would be \$117 million, which would still be quite a bit below \$130 million, which we believe to be a reasonable expectation based on management's vague guidance, as explained above. (We note that, before the latest announcement of construction cost increase, J.P. Morgan had a more pessimistic base-case for future Palms EBITDA at \$90 million, with a "bull case" scenario of \$117 million.<sup>13</sup>)

Furthermore, even if the new Palms could achieve Wynn room rates (\$305 ADR or \$265 RevPAR in 2017),<sup>14</sup> the company would still only reach EBITDA of \$109 million at a 30% margin or \$127 million at a 35% margin according to our model. The latter number would get it close to \$130 million. There is no guarantee the Palms can achieve these rates. Also, while the Strip witnessed an occupancy rate of 93% for FY 2017, Gold Coast (across the street from the Palms) only saw 81% occupancy in 2017, albeit the Gold Coast is an older property than the Palms and is operated by a different company.<sup>15,16</sup> Other departmental revenues in our model, based on Strip resorts, may also drag due to the location of the Palms.<sup>17</sup>

Our analysis does not take into account the additional interest expense for Red Rock's incremental debt incurred for the Palms renovation. How much additional debt will the company have taken on and how much more interest expense will it have to pay by the time it wraps up the \$1 billion project later this year? As of Dec. 31, 2018, the interest rates on its \$1.775 billion term loan B, \$251 million term loan A, and \$245 million revolver were 5.03%, 4.53%, and 4.54% (on an weighted average basis), respectively.<sup>18</sup>

### **Who's on the hook?**

Since the company made its initial announcement of the Palms acquisition and renovation, it has already replaced its CFO and COO (two times). Marc Falcone, the former Deutsche Bank gaming analyst who served as Red Rock's CFO through the IPO in 2016, resigned in May 2017, and the company is on its 3rd new COO – Bob Finch, a long-time Station Casinos executive – since the IPO (Daniel Roy resigned as COO in May 2017 and his replacement, Joseph Hasson, resigned on February 19, 2019).<sup>19,20,21,22</sup>

If the new Palms does not end up generating a sufficient EBITDA return on spending \$1 billion, who in management will get the blame?

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### **Notes**

<sup>1</sup> Red Rock Resorts, Inc., *Red Rock Resorts Announces Agreement to Acquire Palms Casino Resort*, press release, May 10, 2016, <https://www.businesswire.com/news/home/20160510006951/en/Red-Rock-Resorts-Announces-Agreement-Acquire-Palms>.

<sup>2</sup> Red Rock Resorts, Inc., *SEC Form 10-Q*, filed on November 9, 2018, p. 28.

<sup>3</sup> "The increase was primarily due to an increase in non-disrupted Las Vegas operations, partially offset by substantial construction disruption at Palace Station and the Palms."

Red Rock Resorts, Inc., *Red Rock Resorts Announces First Quarter 2018 Results*, news release, May 1, 2018, <http://redrockresorts.investorroom.com/news-releases>

"Also, as previously discussed, we expect the construction disruption at the palms to remain significant through the completion of Phase II of the redevelopment plan."

Red Rock CFO Stephen Cootey, *Q3 2018 Earnings Call Transcript*, November 7, 2018,

<https://seekingalpha.com/article/4219651-red-rock-resorts-rrr-ceo-frank-fertitta-q3-2018-results-earnings-call-transcript?part=single>

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“These full year consolidated results were negatively impacted by substantial construction disruption at the Palms and Palace Station throughout the year.”

Red Rock CFO Stephen Cootey, *Q4 2018 Earnings Call Transcript*, February 12, 2019,

<https://seekingalpha.com/article/4240382-red-rock-resorts-rrr-ceo-frank-fertitta-q4-2018-results-earnings-call-transcript?part=single>

<sup>4</sup> Red Rock Resorts, Inc., *Red Rock Resorts Announces Fourth Quarter and Year End 2017 Results*, news release, February 27, 2018, <http://redrockresorts.investorroom.com/2018-02-27-red-rock-resorts-announces-fourth-quarter-and-year-end-2017-results>

<sup>5</sup> Red Rock Resorts, Inc., *SEC Form 10-Q*, filed on November 9, 2018, p. 28.

<sup>6</sup> Red Rock Resorts, Inc., *Q3 2018 Earnings Call Transcript*, November 7, 2018, <https://seekingalpha.com/symbol/RRR/earnings/transcripts>

<sup>7</sup> Red Rock Resorts, Inc., *Q3 2017 Earnings Call Transcript*, November 7, 2017, <https://seekingalpha.com/symbol/RRR/earnings/transcripts>

<sup>8</sup> Steve Cootey commenting on the ramp period for the Palms: “So we’re thinking yes probably do couple of years before we get fully ramped.”

Red Rock Resorts, Inc., *Q3 2017 Earnings Call Transcript*, November 7, 2017, <https://seekingalpha.com/symbol/RRR/earnings/transcripts>

<sup>9</sup> Average number of hotel rooms per Las Vegas Strip licensee reporting \$72 million annual revenue or more is 3,158. The figure was calculated using the available rooms for FY 2018 (27,661,834) divided by the number of days (365) divided by the number of licensees (24).

Nevada Gaming Control Board, *Nevada Gaming Abstract 2018*, pp. 55-60, <https://gaming.nv.gov/index.aspx?page=144>

<sup>10</sup> Red Rock’s historical EBITDA margins for Las Vegas operations are calculated from the company’s quarterly earnings press releases. The calculation is adjusted EBITDA divided by net revenues. The EBITDA margins for each quarter were then used to calculate an average EBITDA margin over the time period.

<sup>11</sup> Nevada Gaming Control Board, *Monthly Revenue Report: December 2018*, Clark County Las Vegas Strip Area - \$72,000,000 and Over Revenue Range, p. 17, <https://gaming.nv.gov/index.aspx?page=149>

<sup>12</sup> Nevada Gaming Control Board, *Nevada Gaming Abstract 2018*, pp. 55-60, <https://gaming.nv.gov/index.aspx?page=144>

<sup>13</sup> J.P. Morgan North America Equity Research, *Red Rock Resorts: 3Q18 Takeaways, Challenging as Expected. Stay OW. PT to \$30*, November 7, 2018,

<sup>14</sup> Wynn Resorts, Ltd, *SEC Form 10-K*, filed on February 28, 2018, p. 42.

<sup>15</sup> Nevada Gaming Control Board, *Nevada Gaming Abstract 2017*, p. 2-22, <https://gaming.nv.gov/index.aspx?page=144>

<sup>16</sup> Boyd Gaming Corporation, *SEC Form 10-K*, filed on February 26, 2018, p. 3.

<sup>17</sup> During a National Labor Relations Board proceeding on April 16, 2018, the Palms’ Director of Food & Beverage acknowledged that some high-end nightclubs on the Las Vegas Strip are in a position to earn more revenue than the Palms, owing to their location. The same person acknowledged that the Palms has gotten less foot traffic relative to casino hotels directly on the Las Vegas Strip, although he projected an increase due to the renovations.

National Labor Relations Board, Region 28, *Case No. 28-RC-217964*, April 16, 2018, pp. 79, 81-16.

<sup>18</sup> Red Rock Resorts, *SEC Form 10K*, filed on February 26, 2019, p. 90,

<https://www.sec.gov/Archives/edgar/data/1653653/000165365319000005/rrr10-kx12x31x2018.htm>

<sup>19</sup> Marc Falcone CFO resignation, appointment of Stephen Cootey to CFO.

Red Rock Resorts, *SEC Form 8-K*, filed on May 25, 2017,

<https://www.sec.gov/Archives/edgar/data/1653653/000119312517182439/0001193125-17-182439-index.htm>

<sup>20</sup> Daniel Roy COO resignation, appointment of Joseph Hasson to EVP of Operations.

Red Rock Resorts, *SEC Form 8-K*, filed on May 16, 2017,

<https://www.sec.gov/Archives/edgar/data/1503579/000119312517170971/d394625d8k.htm>

<sup>21</sup> Joseph Hasson COO at Red Rock Resorts since August 2017.

Red Rock Resorts, *SEC Form DEF14A*, filed on April 19, 2018, p. 21,

<https://www.sec.gov/Archives/edgar/data/1653653/000119312518121756/d572117ddef14a.htm>

<sup>22</sup> Joseph Hasson COO resignation, appointment of Robert A. Finch to COO.

Red Rock Resorts, *SEC Form 8-K*, filed on February 19, 2019,

<https://www.sec.gov/Archives/edgar/data/1653653/000119312519043402/d704405d8k.htm>