MOODY'S
INVESTORS SERVICE

ANALYSIS

Harrah's Entertainment, Inc.

Las Vegas, Nevada, United States

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Moody's Investors Service recently upgraded Harrah's Entertainment, Inc.'s (Harrah's) Speculative Liquidity Rating (SGL) to SGL-3, revised the rating outlook to positive and affirmed the company's Caa3 Probability of Default and Corporate Family Ratings. Key issues considered in these decisions are explained in the Credit Opinions. This Analysis provides further insight into select issues that factored into our decisions.

» Harrah's has taken steps to improve its liquidity profile by eliminating several possible default triggers.

» Still, we don't believe that the company's earnings will increase enough over the next few years to improve its leverage and coverage metrics. And Harrah's significant debt service burden leaves the company with insufficient free cash flow for maintenance of existing assets or growth initiatives.

» Harrah's will likely need to reduce debt by selling assets, going public, or restructuring its debt burden. Restructuring would likely result in impairment to debt holder claims, and obstacles accompany all of these options.

» Thus, we believe Harrah's credit profile will remain weak for the foreseeable future because gaming demand isn't likely to rebound or to reach previous peaks quickly.

This Analysis provides an in-depth discussion of credit rating(s) for Harrah's Entertainment, Inc. and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

Overview

The state of the U.S. gaming industry has been depressed since the start of the severe downturn that accelerated in September 2008. Companies in the sector have grappled with a reduction in gaming demand, and it's clear that any recovery will continue to lag behind the general economy. Since closing the leverage buyout in January 2008, Harrah's has had to slash capital spending and operating costs and pursue several distressed debt exchanges to reduce debt and extend maturities in an effort to avoid bankruptcy.

Despite these events, Harrah's long-term credit profile remains weak with debt/property EBITDA over 10 times and property EBITDA/interest under 1.5 times (refer to Chart 1). Harrah's has made several moves recently to improve its liquidity profile, which will give the company breathing room through 2013, if all the announced transactions close.

We don't, however, view these developments as a sign that Harrah's is out of the woods; we believe the company has deferred -- not solved -- its problems. Harrah's consolidated interest burden of nearly $1.7 billion consumes about 90% of property EBITDA, leaving insufficient free cash flow for debt reduction or capital spending. We are also concerned that Harrah's isn't investing enough in its properties, which will hurt its competitive position over time. Additionally, management seems more interested in jump-starting growth initiatives than in reducing debt.

TABLE 1

	HARRAH'S ENTERTAINMENT, INC.			HARRAH'S OPERATING COMPANY			PROPCO		
UNIT: $ MILLIONS	**2007**	**2008**	**2009**	**2007**	**2008**	**2009**	**2007**	**2008**	**2009**
Revenues	10,825	10,127	8,907	8,144	7,695	6,873	2,681	2,432	2,034
yr-yr % chg	*11.9%*	*-6.4%*	*-12.0%*		*-5.5%*	*-10.7%*		*-9.3%*	*-16.4%*
Property EBITDA	2,826	2,416	2,154	1,994	1,700	1,597	832	716	556
yr-yr % chg	*8.2%*	*-14.5%*	*-10.9%*		*-14.7%*	*-6.0%*		*-13.9%*	*-22.3%*
Property Margin	26.1%	23.9%	24.2%	24.5%	22.1%	23.2%	31.0%	29.4%	27.4%
Balance Sheet Debt	12,440	23,209	18,943	-	16,709	13,392	-	6,500	5,551
Face Amount of Debt	12,440	24,500	22,052	-	18,000	17,354	-	6,500	5,551
Due to HET						854			
Interest Expense	827	1,585	1,772	-	1,312	1,485	-	273	287
Debt/Property EBITDA	4.4	10.1	10.2	-	10.6	10.9	-	9.1	10.0
Property EBITDA/Interest	3.4	1.5	1.2	-	1.3	1.1	-	2.6	1.9

Notes: Refer to capital structure and organization chart at end of this report.

Intermediate-Term Liquidity Gives Harrah's Clearance

In the second quarter, Harrah's boosted its liquidity via issuance by Harrah's Operating Escrow LLC (a wholly owned subsidiary of Harrah's Operating Company, Inc. (HOC), which is a wholly owned subsidiary of Harrah's) of $750 million second lien debt. With this transaction, we estimate that Harrah's has $1.4 billion available under its $1.6 billion revolver, which will be more than sufficient to fund the company's negative free cash flow over the next few years.

We also believe that HOC can maintain compliance with its senior net secured debt/EBITDA covenant. Factoring in a previously announced agreement to amend the collateralized mortgage obligation (CMBS) loan, which includes an extension of the maturity to February 2015 from February 2013, Harrah's won't have any significant debt maturities until 2015. These transactions eliminate two potential default triggers.

Additionally, the company announced in June 2010 a debt-for-equity transaction that's expected to close by the first quarter of 2011. Harrah's said it entered into definitive agreements with Apollo Management VI, L.P. and TPG Capital, L.P. -- the company's equity sponsors -- and hedge fund Paulson & Co. Inc. to exchange $1,118 million face amount of debt at a specified exchange ratio for up to approximately 15.6% of the common equity of Harrah's.

This transaction, as proposed, will provide Harrah's with a cash infusion of about $557 million. We believe Harrah's will use a large portion of this cash to fund capital spending – not debt reduction. Nevertheless, the cash infusion indirectly benefits HOC because cash can either be down streamed or lent internally to the operating company, if needed.

These transactions contributed to the recent upgrade of Harrah's Speculative Grade Liquidity Rating to SGL-3 from SGL-4, as well as the change in its rating outlook to positive from negative.

TABLE 2

Harrah's Entertainment, Inc.

Simplified Liquidity Picture

	HET		HOC	
	2010	2011	2010	2011
EBITDA	1,900.0	1,975.0	1,500.0	1,575.0
Cash Taxes	(30.0)	(30.0)	(30.0)	(30.0)
Cash Interest	(1,700.0)	(1,700.0)	(1,500.0)	(1,500.0)
Maintenance Capex	(300.0)	(300.0)	(200.0)	(200.0)
Fees to Sponsors and Other Unidentified	(100.0)	(100.0)	(100.0)	(100.0)
Cash Flow Before Debt Maturities	(230.0)	(155.0)	(330.0)	(255.0)
Bond Issuance	730.0	-	730.0	-
Equity Infusion		557.0		
Bond Redemptions and Debt Maturities	(365.0)	(75.0)	(365.0)	(75.0)
Revolver Repayment	(427.0)	-	(427.0)	-
Change in Cash	(292.0)	327.0	(392.0)	(330.0)
Beginning Cash	918.0	626.0		
Plus: Change in Cash	626.0	953.0		
Less: Cage Cash	500.0	500.0		
Ending Available Cash	126.0	453.0		
Revolver Commitment	1,630.0	1,630.0		
Revolver Drawing / (Repayments)	(427.0)	-		
Revolver Outstanding, incl LOCs	135.0	135.0		
Availability	1,495.0	1,495.0		

Notes: Cash can be freely moved between HET and HOC

Growth Spending Likely at the Expense of Debt Reduction

Harrah's management seems more interested in jump-starting growth initiatives than in reducing debt. Harrah's assumed debt as part of its Planet Hollywood Resort and Casino acquisition and recently announced the acquisition of Thistledown racetrack. In announcing the separate debt-for-equity investment with equity sponsors and a hedge fund, Harrah's said the equity injection will be used for "further balance sheet optimization and strategic investments." So it appears to us that Harrah's will not use much of the expected equity investment to reduce debt.

Harrah's Must Address Its Significant Debt Burden

Harrah's property EBITDA has tumbled in recent years, dropping to $2.1 billion in 2009 from $2.8 billion in 2007. Margins have declined as well (see graphs). Despite debt exchanges that eliminated about $5 billion of debt and substantial cost reductions that have helped offset some of the decline in EBITDA, Harrah's leverage remains above 10 times and EBITDA coverage of interest is thin.

FIGURE 1

Property EBITDA

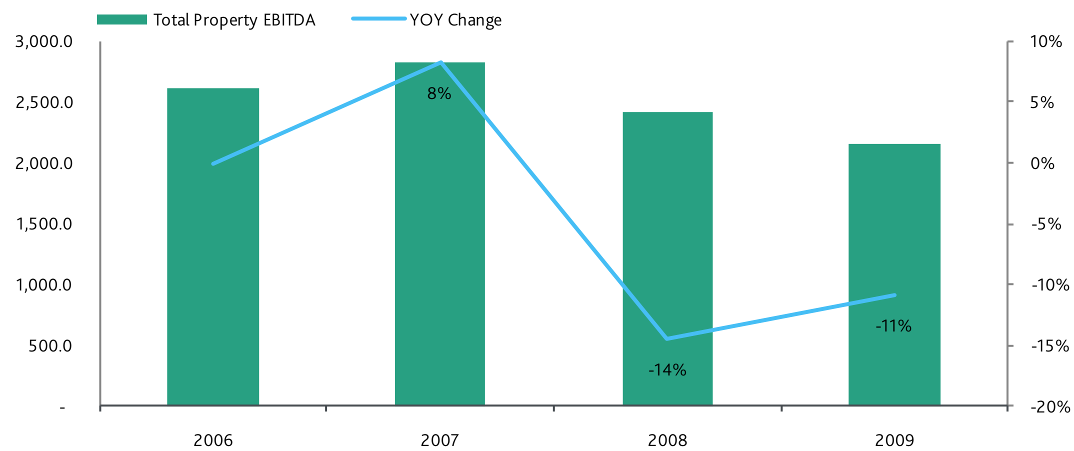
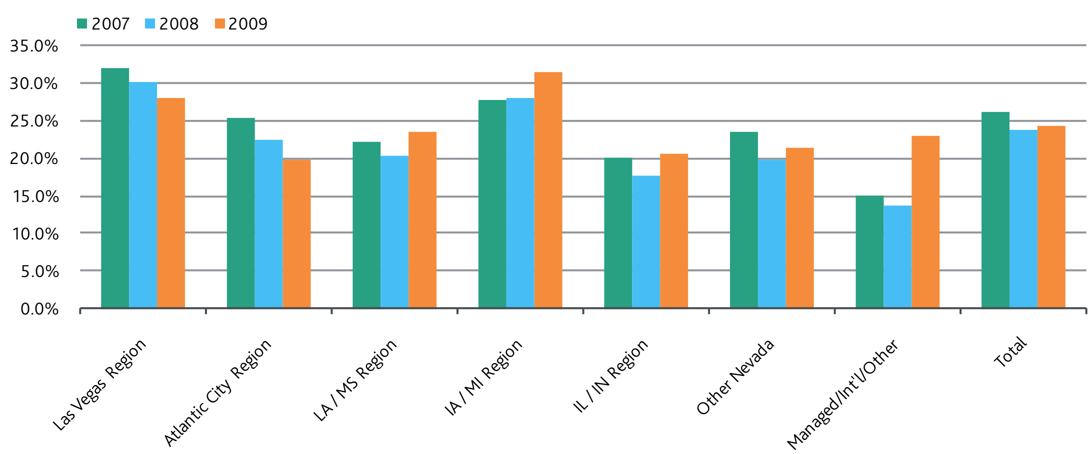


FIGURE 2

Property EBITDA Margins



Assuming Harrah's debt remains around $22 billion, consolidated 2009 EBITDA of $1.9 billion would need to increase about 40% to reduce debt to EBITDA to 8.0 times, and increase EBITDA/interest to about 1.5 times. This would still represent a highly leveraged capital structure, considering the gaming industry's vulnerability to recessions and consumer flight.

We do expect U.S. gaming markets to rebound at some point, but we don't expect them to reach previous peaks anytime soon. Worse, the number of U.S. casinos could increase as more states consider approving gaming to satisfy budget deficits. Although Harrah's could benefit from this growth, industry expansion appears to be a zero-sum game: as new markets open, existing ones are cannibalized. We therefore don't believe Harrah's can simply grow out of its over-leveraged position in the near term by significantly increasing earnings and internally-generated cash.

Although Harrah's ratings may rise slightly if the pending transactions we outlined above close and boost the company's liquidity (and reduce the probability of default), we wouldn't expect ratings to rise out of the Caa rating category any time soon.

Harrah's Capital Structure

Harrah's has a complicated legal and capital structure. Moody's ratings are based upon a consolidated assessment of Harrah's because, in our view, it is unlikely management would jeopardize the loss of the real estate pledged to the CMBS lenders. Harrah's continues to manage the consolidated company on a centralized basis, and Harrah's and HOC is managed by one board of directors and one management team. As part of our rating process, we also review the credit of the operating company on a standalone basis.

In early 2008, HOC transferred the real estate associated with six casino properties (Paris Las Vegas, Harrah's Las Vegas, Rio Las Vegas, Flamingo Las Vegas, Harrah's Atlantic City and Harrah's Laughlin) to indirect, wholly-owned, unrestricted special-purpose subsidiaries of Harrah's. These properties are operated by separate indirect wholly-owned unrestricted subsidiaries of Harrah's.

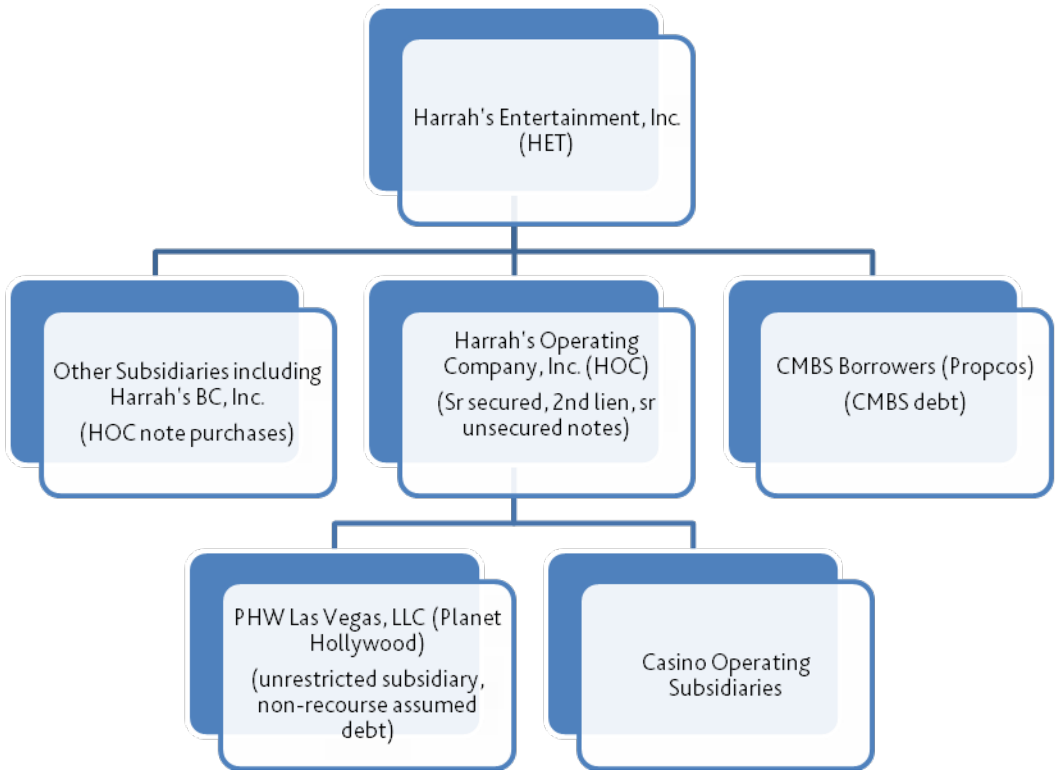
The CMBS loan issued by the special purpose subsidiaries is secured by the real estate underlying the six transferred properties and the related operating leases. The CMBS loans are serviced by rent due under the operating leases and the lease payments are guaranteed by Harrah's. HOC owns and operates the remaining 46 owned or managed properties.

HOC's senior secured bank facilities and $2.095 billion first lien notes are secured by all assets but are not directly guaranteed by domestic subsidiaries. However, the bank facilities and the first lien notes effectively benefit from the subsidiary guarantee provided to the operating company's 10.75% senior unsecured notes. Pursuant to a guarantor inter-creditor agreement between the banks and certain noteholders, the trustee under HOC's 10.75% senior unsecured subsidiary guaranteed notes must turn over to the bank lenders any payments received in respect of any subsidiary guaranty. The bank agent will distribute proceeds so turned over in accordance with the terms of a collateral agreement between the company, the subsidiary pledgors, the trustee, and the collateral agent. A first lien inter-creditor agreement between the banks, the trustee and collateral agent will provide that the proceeds be shared ratably among all of the first lien debt holders. As a result of these contractual arrangements, the bank facilities and the first lien notes are effectively pari-passu and rank as the most senior debt obligations.

Refer to Figure 3 for organizational chart.

FIGURE 3

Organizational Chart



Conclusion

Harrah's has deferred its short-term credit concerns, but its longer-term issues remain. We don't expect the U.S. economic recovery, which remains tepid, to allow the company merely to grow its way back to a stronger credit profile.

In the absence of a significant increase in gaming demand, Harrah's operating performance will remain weak. As a result, we believe Harrah's will continue to pursue transactions to improve its capital structure and liquidity position, but these are likely to impair debt holder claims.

Moody's Related Research

Rating Actions:

» Moody's upgrades Harrah's SGL rating and changes rating outlook to positive, June 2010

» Moody's assigns Ca to Harrah's proposed $500 million 2nd priority notes; Caa3 CFR affirmed, April 2010

Credit Opinion:

» Harrah's Entertainment, Inc., June 2010

Industry Outlook:

» Annual Outlook: U.S. Gaming Recovery Still Faces Long Odds, December 2009 (121769)

Sector Comment:

» U.S. Gaming Revenues: One Step Closer to the Bottom?, November 2009 (121186)

Rating Methodology:

» Global Gaming, December 2009 (121812)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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