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SPECIAL COMMENT

High Energy Prices Threaten the Stability of the U.S. Gaming Sector

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» High fuel prices will likely take a toll on the U.S. gaming industry because consumers tend to scale back on casino trips when they are forced to pay more to heat their homes and at the pump. In the short term, this could neutralize all, or a considerable portion, of the favorable impact on earnings that the sector has experienced in recent months. Over the long haul, it could prompt us to revise our U.S. Gaming Sector Industry Outlook to negative from stable.

» By and large, the low ratings of companies in the sector [roughly a third have a Corporate Family Rating (CFR) of Caa1 or below] already take into account the risk of further economic weakness, so we do not expect a rash of downgrades. However, a protracted increase in gas prices may pressure ratings over time.

» Markets most affected by higher fuel prices are those like Lake Charles, La., where many customers have to travel more than 75 miles to get to casinos owned by Pinnacle Entertainment Inc. (B2, negative), Isle of Capri Casinos Inc. (B3, ratings under review for possible upgrade), and Boyd Gaming Corp. (B2, stable). In addition, companies with a large presence on the Las Vegas Strip, such as Caesars Entertainment Corp. (Caa2, stable) and MGM Resorts International (B3, stable), are vulnerable to increases to the cost of air travel as well as rising gas prices because a large number of visitors drive from California.

» Companies that derive the bulk of their revenue overseas, like Wynn Resorts Limited (Ba3, positive) and Las Vegas Sands Corp. (Ba3, stable), will fare better. In addition, a few densely populated markets, such as the Philadelphia metropolitan area, may have some hedge against higher fuel prices because the drive time for most customers is relatively short. However, we believe this advantage for companies like SugarHouse HSP Gaming Prop. Mezz (B3, stable) and Chester Downs and Marina LLC (B3, stable) will be temporary because over time, high energy prices will dissuade those gamblers too.

Pain at the pump could reverse recent trends

The U.S. gaming sector is dependent upon the discretionary spending of consumers. As such, we believe anything that puts pressure on the U.S. economy—including a material and sustained spike in the price of fuel—would cause sector revenue and profits to decline.

Most gamblers across the U.S. drive to casinos. As higher energy prices erode personal discretionary income, gaming customers will likely react by taking fewer trips to casinos, spending less while they are there, and shortening their stays.

The severity of the impact will depend upon the duration. Over the short term, higher energy prices could neutralize all or most of the positive earnings momentum that had been underway as companies were beginning to cash in on the cost cutting they undertook during the Great Recession and gamblers were starting to visit and spend more.

However, the relatively low ratings of most casino companies already captures some risk of continued economic weakness. Approximately 30% of Moody's rated U.S. gaming issuers have a CFR of Caa1 or lower, while 24% have a CFR of B3 and 24% have a CFR of B2.

The overall cash flow and liquidity profiles of U.S. casino companies have improved. But in many cases, this has come as a result of bankruptcies and other types of restructurings that have reduced the sector's overall debt burden. To some degree, the relative improvement in financial flexibility, even at weaker rating levels, could help companies manage through a short-term surge in fuel prices. However, a protracted period could be challenging, especially for weaker companies.

In addition, an extended period of high energy prices—or a similar economic event that would hurt consumer demand for gaming—could negatively affect company earnings to the point where we would consider changing our U.S. Gaming Industry Outlook from stable to negative. This could happen if we believe monthly gaming revenue will fall at a rate greater than 2% and overall gaming company operating profits will fall at a rate greater than 4%, and if we believe these rates of decline are sustainable for the next six to 12 months.

Regional markets and the Las Vegas Strip are susceptible

Regional gaming markets in the U.S. are considered drive-in markets, and that drive can be considerable. As a result, sticker shock at the gas pump could discourage gamblers already stretched by higher energy costs from traveling to a specific casino or market. We believe this is especially true for gaming markets where a majority of gamblers have to drive 75 miles or more to get to casinos.

For example, Pinnacle Entertainment's very successful L'Auberge du Lac casino in Lake Charles is the closest full-scale casino hotel to Houston, Tex. And Houston is the sixth-largest metropolitan statistical area in the U.S. and currently accounts for about one-third of L'Auberge's gaming customers. But Lake Charles is 140 miles away from Houston, and that trip becomes a more expensive proposition for Houston gamblers as gas prices increase.

The Las Vegas Strip is also vulnerable because a good portion of its customers make the four-hour drive from Southern California, while almost 50% of its customers arrive by plane, and airlines already have started charging higher prices to customers to cover their higher fuel costs. Companies most at risk are MGM Resorts and Caesars Entertainment, which derive a significant chunk of their revenue and EBITDA (earnings before interest, taxes, depreciation, and amortization) from the Las Vegas Strip. In contrast, Las Vegas Sands and Wynn Resorts get about 75% of their revenue and profits from overseas markets.

Separately, rising fuel prices will also cause operating costs to increase which, if sustained, could take a bite out of margins, particularly for companies that operate large casino resorts.

A few densely populated markets, such as the Philadelphia metropolitan area, may have some hedge against higher fuel prices because the drive time for most customers is relatively short, and this market benefits from convenient available mass transit options. However, we believe the benefits to companies in or near the Philadelphia metropolitan market—SugarHouse HSP Gaming Prop. Mezz and Chester Downs and Marina LLC—would be largely temporary. Persistently high fuel prices would make even nearby customers more reluctant to spend money on casino gaming.

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