

Union Gaming White Paper

Chicago casino opportunity
flying under the radar

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Union Gaming is the leading boutique investment bank and advisory firm focused exclusively on the global gaming industry. We offer traditional investment banking services to a wide range of clients globally, and through our thought leadership businesses, we advise and support institutional investors, governments and industry stakeholders.

About Union Gaming Analytics

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Executive summary

Revised Chicago casino bill

In late May, the Illinois legislature passed Public Act 101-0648¹, which, among other gaming-related items, provided a fix to last year's gaming expansion bill that established an exceptionally onerous gaming revenue tax on the casino license destined for the City of Chicago. Union Gaming Analytics produced the financial feasibility study on behalf of the Illinois Gaming Board for the Chicago casino, which we found to be decidedly not feasible, driven primarily by an effective gaming revenue tax north of 70%.

Public Act 101-0648 has restructured the AGR² tax to be significantly more palatable for potential developers, although it does remain higher than the statutory tax rate schedule for all of the state's other casinos. Ultimately, and based on an AGR mix that, while still slot-centric, has a greater proportion of table games revenue than the peers, the effective tax rate on AGR should be around 40%, or lower, as detailed herein. This, in our view, should be an attractive-enough effective tax rate to result in a successful RFP process, which we think should be delayed until next year in order to allow more-financially viable gaming developers enough time to work through the ongoing COVID-19 disruptions and more properly assess their growth strategies and participation in the Chicago casino RFP.

While the Chicago casino fix is already "old news," having been signed into law in late June by Governor Pritzker, we believe it received scant attention on the part of casino developers. The combination of COVID-19 casino shutdowns, emergency financings to bolster balance sheets, and putting development plans / teams on ice, has resulted in the Chicago casino opportunity largely flying under the radar.

Reconciliation fee payment period extended

Although we really don't like the concept of what is effectively a retroactive license fee, the bill gives all new casino licensees some relief there too. Recall that all of the new casino licenses are required to pay an upfront fee per gaming position of \$30,000 (casinos in Cook county) or \$17,500 (all other counties). Given that the Chicago casino is eligible for up to 4,000 positions, it will be subject to up to \$120 million in upfront per-position fees. Then, after the first three years of operations, the reconciliation fee is calculated as 75% of the highest AGR over any given rolling 12-month period, less upfront fees paid. For illustrative purposes, we estimated approximately \$800 million in AGR at the highest performing Chicago site in last year's financial feasibility study. This would imply a reconciliation fee of \$480 million (\$800 million of AGR x 75%, less the \$120 million in upfront per position fees already paid). The 2019 bill required the payment of this reconciliation fee over a two-year period with interest. The 2020 bill changes this to a more palatable six-year payment schedule without interest.

Free play not taxed

Unchanged relative to the 2019 bill, free play will no longer be subject to AGR taxes. Per the legislation, the calculation of AGR shall not include the dollar amount of non-cashable vouchers, coupons, and electronic promotions, not to exceed 20% of AGR. This has already gone into effect and is applicable to all existing and future Illinois casinos. This is significant and should allow the Illinois casinos to more effectively compete with the border casinos in Indiana, Iowa, and Missouri.

¹ <https://ilga.gov/legislation/publicacts/101/PDF/101-0648.pdf>

² AGR refers to Adjusted Gross Receipts, which is the terminology employed by Illinois to refer to what is commonly known as GGR, or gross gaming revenue, elsewhere

Largest number of positions in Illinois

The Chicago casino license is eligible for up to 4,000 gaming positions, which would allow it to be the largest casino in Illinois by a significant margin. For comparison, the ten existing Illinois casinos were previously limited to a cap of 1,200 gaming positions, with the cap raised to 2,000 as part of the 2019 legislation although no casinos have expanded yet (the 800 new positions would also be subject to the upfront per position fees and reconciliation payment structure as the new casinos).

Total Chicagoland supply

In theory, Illinois gaming expansion, including the Chicago casino, could more than double the amount of gaming supply in the Chicagoland area as highlighted in the table below. However, a significant amount of the supply in the “eligible/planned” category is unlikely to come to fruition. For example, only some of the existing casinos might move forward with position increases due to the onerous fee structure. Similarly, Arlington Park has already said “no” to operating a racino for similar reasons. Combined, there are likely thousands of positions out of the 13,600 in the eligible/planned category that won’t come online. Further, just because a new casino/racino is eligible to operate a given number of positions doesn’t mean they will operate 100% of their eligible capacity.

Figure 1: Chicagoland gaming positions

Property	Slots	Tables	Total Positions
Existing			
IL Grand Victoria - Elgin	1,088	42	1,199
IL Harrah’s - Joliet	1,093	39	1,194
IL Hollywood - Aurora	1,017	42	1,135
IL Hollywood - Joliet	1,100	16	1,080
IL Rivers - Des Plaines	995	54	1,191
IN Ameristar East Chicago	1,793	85	2,064
IN Horseshoe Hammond	2,135	152	2,727
IN Majestic Star	1,646	63	1,811
Total existing casinos	10,867	493	12,401
Eligible/Planned			
Chicago casino			4,000
Existing IL casino expansions (allowed up to 800 new positions each)			4,000
South suburban casino			2,000
South suburban racino			1,200
Arlington Park			1,200
Hawthorne Racecourse			1,200
Total eligible/planned			13,600
Grand total			26,001

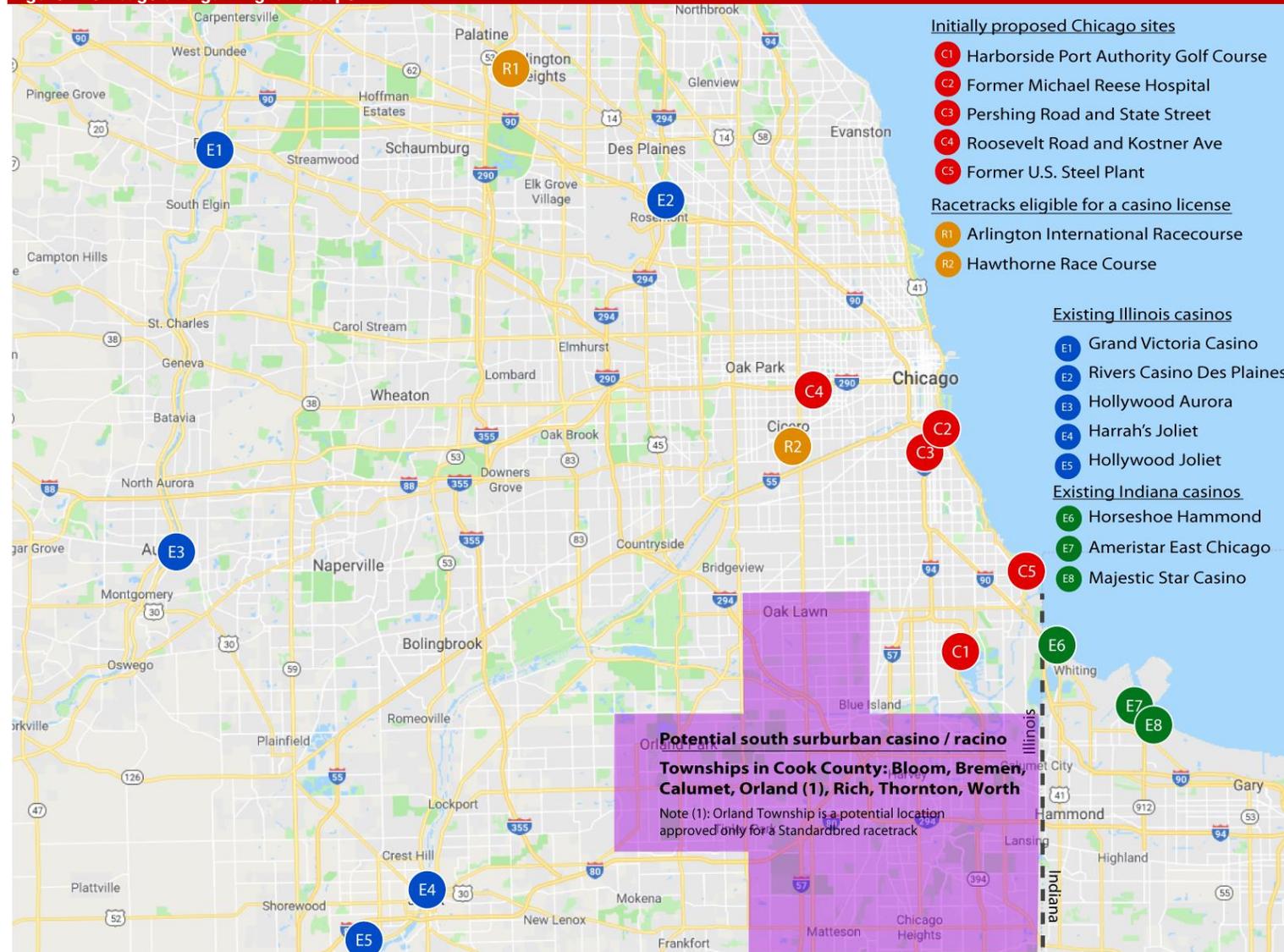
Source: Union Gaming, Illinois Gaming Board, Indiana Gaming Commission

Note: Positions calculated using Illinois’ formula of slots at 0.9 positions each, craps at 10, all other tables at 5

Site agnostic

The City of Chicago had initially selected five specific sites for inclusion in the financial feasibility study. These sites were generally outside of the central business district and tourist-centric areas, and would likely not have been the preferred sites by casino developers. Importantly, we do not believe any of these sites would today be required for development as part of the eventual RFP. Rather, we believe that developers will have the liberty to choose any site they believe is most suitable (although still subject to approval). This is another positive that would allow a developer to focus on a site that offers the best possible economics, rather than being forced into a location in need of economic regeneration. The below map highlights the existing Illinois and Indiana casinos, as well as other authorized new casino / racetrack casino locations in the Chicagoland area. The map also highlights the five sites that were the subjects of the feasibility study, although, as noted above, we do not believe developers will be bound to these sites on a go-forward basis. Not depicted on the map is the license destined for Waukegan in the northern suburbs.

Figure 2: Chicagoland gaming landscape



Source: Union Gaming

Effective tax rate on AGR

The current graduated tax rates paid on total AGR (without differentiating between slots or tables) by all ten Illinois casinos are as follows:

- 15% of all AGR up to \$25 million
- 22.5% between \$25 and \$50 million
- 27.5% between \$50 and \$75 million
- 32.5% between \$75 and \$100 million
- 37.5% between \$100 and \$150 million
- 45% between \$150 and \$200 million
- 50% above \$200 million

However, the gaming expansion bill passed in 2019 will notably alter the tax scheme by introducing a more favorable and separate tax rate on table games (while leaving the above graduate tax schedule applicable to slots). The new, lower, graduated tax scheme on table games went into effect on July 1, 2020 (this was a change implemented in the 2020 bill, as the 2019 bill had the opening of the first new casino as the trigger for the separate table games tax to begin). The graduated table games tax rates are as follows:

- 15% of table AGR up to \$25 million
- 20% above \$25 million

AGR tax specific for the Chicago license

As initially contemplated per the 2019 legislation, the Chicago casino license would be subject to the same graduated tax rates as all other casino licensees, but would also be subject to an additional 33.3% tax on all forms of AGR that was unique to Chicago. This, among other concerns, resulted in our finding that the casino would not be feasible given an effective tax rate above 70%.

Public Act 101-0648 introduces a second graduated AGR tax scheme that is applicable only to the Chicago license. The AGR taxes are as follows:

Figure 3: AGR tax schedule for the Chicago casino license

Slots	State	City	Total
\$0-25 million	12.0%	10.5%	22.5%
\$25-50 million	16.0%	14.0%	30.0%
\$50-75 million	20.1%	17.4%	37.5%
\$75-100 million	21.4%	18.6%	40.0%
\$100-150 million	22.7%	19.8%	42.5%
\$150-225 million	24.1%	20.9%	45.0%
\$225 -1,000 million	26.8%	23.2%	50.0%
\$1,000 million+	40.0%	34.7%	74.7%
Table Games	State	City	Total
\$0-25 million	8.1%	6.9%	15.0%
\$25-75 million	10.7%	9.3%	20.0%
\$75-175 million	11.2%	9.8%	21.0%
\$175-225 million	13.5%	11.5%	25.0%
\$225-275 million	15.1%	12.9%	28.0%
\$275-375 million	16.2%	13.8%	30.0%
\$375 million+	18.9%	16.1%	35.0%

Source: Union Gaming, State of Illinois

Effective AGR tax rate for the Chicago license ~40%

The effective tax rate on AGR will, of course, vary based on total anticipated AGR, as well as the mix of AGR given that tables will be taxed at notably lower rates than slot machines. In the financial feasibility study for Chicago, we had derived an estimate of \$805.9 million in AGR for the highest performing of the five sites we were directed to analyze. In the below matrix, this effectively represents the baseline AGR (at \$800 million), with the range spanning from \$600 million to \$1.2 billion in \$200 million increments. With respect to the overall mix of AGR, the range is 80% slots / 20% tables to 60% slots and 40% tables across 500bps increments.

Ultimately, the effective tax rate on AGR hovers around 40%, within a range of 34% to 42%. For comparison purposes, the effective tax rate paid by the existing 10 Illinois casinos in 2019 was approximately 31%, exclusive of admissions taxes. The highest performing casino in Illinois in 2019 was Rivers, which paid an effective tax rate on AGR of approximately 42% (albeit based on the previous tax structure that did not differentiate between slots and tables).

Figure 4: Chicago casino effective AGR tax matrix

Slot / Table mix	Total AGR (\$mm)			
	\$600	\$800	\$1,000	\$1,200
80% / 20%	40%	41%	42%	42%
75% / 25%	38%	40%	40%	41%
70% / 30%	37%	38%	39%	40%
65% / 35%	36%	37%	38%	39%
60% / 40%	34%	36%	37%	38%

Source: Union Gaming

Chicago will be competing against lower-taxed peers

The Chicago casino will face a higher effective AGR tax than both its in-state and out-of-state peers. Highlighted in the table below, the IL Chicagoland peer group paid an average effective tax rate of 35% in 2019, and the three northwest Indiana peers paid an average of 29%. Noted above, the Illinois peers will pay lower taxes on table games going forward, which will make them notably more competitive with the Indiana casinos.

Figure 5: Illinois and Indiana Chicagoland effective AGR tax rates (CY2019 and FY2019, respectively)

Casino	AGR (\$mm)	AGR Taxes	Effective rate
Grand Victoria - Elgin	156.0	45.8	29%
Harrah's - Joliet	171.6	52.9	31%
Hollywood - Aurora	114.6	29.9	26%
Hollywood - Joliet	115.6	30.2	26%
Rivers - Des Plaines	450.5	190.9	42%
Total IL Chicagoland	1,008.4	349.6	35%
Ameristar East Chicago	226.7	65.7	29%
Horseshoe Hammond	386.7	127.9	33%
Majestic Star	150.5	29.1	19%
Total NW Indiana	763.9	222.7	29%

Source: Union Gaming, Illinois Gaming Board, Indiana Gaming Commission

RFP timing

The City of Chicago has been in a position to conduct the casino RFP since the legislation was signed into law in late June. Importantly, however, the city has not moved forward at this point given the pandemic and its impact on casino developers. The reality is that while the balance sheets of major casino developers have generally been shored up during the COVID pandemic, there are significant unknowns with respect to recoveries of markets like Las Vegas, or if lockdowns will return to regional markets, to name just two examples. Ultimately, we do not think major casino developers would be willing to commit a billion dollars (or even several hundred million dollars) if an RFP were held today.

Recommending a spring 2021 target

We believe that, to the extent possible given the current fiscal situation in Chicago, the city would be better served to delay any RFP until next year in order to allow potential RFP participants the time needed to better understand, quite simply, what the casino business will look like on a go-forward basis, and how a major metropolitan urban greenfield development might fit in to this new paradigm, not to mention the need for a more stable project financing environment. To the extent there is any movement with the Chicago casino license this year, a non-binding RFI (request for information) would be a better way to take the temperature of casino developers.

Casino development timeline – doors open in 2025

Under the assumption that an RFP is held in early 2021, we would anticipate a license to be granted by the Illinois Gaming Board by year-end 2021. Given the complexities of an urban development, and under the assumption that the casino would be more than slots-in-a-box, a three-year development timeline is more likely than not. This implies an opening in early 2025.

However, like all of the other new Illinois casino licenses, the Chicago casino will be eligible to operate a temporary casino for up to two years (with the possibility of a 12-month extension) while the permanent facility is constructed. This too would have the effect of taking a little bit of the sting out of the reconciliation payment.

One-time costs associated with the license

Touched on above with respect to the reconciliation fee, herein we examine the various significant one-time fees and payments associated with the Chicago license (there are many other, but much smaller, one-time fees that we do not attempt to quantify herein). Note that these fees and payments are separate and apart from recurring obligations like the monthly tax on gaming revenue.

Upfront reconciliation fee: \$15mm

All of the new Illinois casino licenses, including the Chicago license, are subject to a \$15 million "reconciliation fee" payable upon license issuance. It is not clear at this time if this fee will be deductible from the reconciliation payment described below.

Upfront per-position fee: \$120mm

The Chicago licensee will be subject to a per-position fee of \$30,000 (while most other new licenses will be subject to a per-position fee of \$17,500). Under the assumption that the Chicago casino utilizes all 4,000 gaming positions, this translates to a \$120 million payment.

Reconciliation payment: \$480mm

All of the new Illinois licenses, including the Chicago license, are subject to a backwards-looking so-called "reconciliation payment" that kicks in after the first three years of operations. This payment is calculated as 75% of the most lucrative 12-month period of AGR less upfront per-position fees paid. For illustrative purposes, we'll assume the same ~\$800 million baseline in AGR for Chicago. This translates to a \$600 million reconciliation payment, less the \$120 million in upfront per position fees already paid, for a net balance due of \$480 million. This amount is then payable over a six-year period without interest beginning in year four (the original bill called for this payment over a two-year period with a modest, yet undefined, interest rate beginning in year four).

Total one-time fees in excess of \$600mm

The above major license-related fees, using an estimate of \$800 million in AGR, total \$615 million, albeit with the majority payable in installments between years four and nine of operations. Most developers will contemplate these fees as part of the overall development budget, suggesting that the hard construction costs might be constrained as a result, especially given the current environment.

Margin profile – is a 25% EBITDA margin possible?

Above, we note that the effective tax rate paid by all ten existing Illinois casinos in 2019 was an average of 31%. While there is no publicly available data regarding profitability of any of the Illinois casinos, we believe EBITDA margins are generally in the mid-20% range. With that in mind, and in the context of the Chicago license likely facing a gaming tax rate that is ~1,000 basis points higher than average, it stands to reason that associated EBITDA margins will be lower than the peer group, although probably not on a one-for-one basis in terms of the tax rate delta. In all likelihood, we would have expected the Chicago license to be closer to a 20% EBITDA margin in a pre-COVID environment.

Post-COVID margin profiles are increasing

Throughout the 2Q20 earnings season, a common refrain has centered around notable EBITDA margin improvement across regional casinos, which should have a degree of permanence. For example, Penn National Gaming noted that they would only need to return to 90% of 2019 revenue in order to capture 100% of 2019 EBITDA. There are a handful of factors driving margin improvement, including:

- A more rational marketing and promotional environment as operators have largely stopped marketing to customers who were unprofitable, or barely profitable
- A more rational labor expense that is appropriate for lower patron headcounts (while average win/patron is increasing as the non-profitable customers are weeded out)
- Operating the right amenities, rather than the (historically) expected amenities
- Working with vendors to pare down expenses

The bottom line is that the pre-COVID mid-20% EBITDA margin range at the existing Illinois casinos could evolve to a mid-30% range in a post-COVID environment (also bolstered by the lower tax structure on table games). With that in mind, it is likely that a Chicago casino could achieve an EBITDA margin profile in the mid-20% range, which potentially makes the opportunity significantly more interesting if these industry-wide margin improvements are sustainable.