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Harrah's is betting on Rhode Island to expand in Northeast

The world's largest casino operator is eager to break into the affluent and densely populated Northeast through its partnership with the Narragansett Indians. But accumulated debt and a potential sale could change the company's strategy.

BY ANDREA L. STAPE /Journal Staff Writer

When the Narragansett Indians first started working with Harrah's Entertainment Inc. in 2002 to bring a casino to West Warwick, Harrah's was a \$4-billion company with 26 casinos in 12 states.

Now, Harrah's is the world's largest casino operator, with 39 casinos in three countries, \$7.1 billion in revenue and an aggressive strategy for continued international expansion.

While Harrah's has almost doubled its revenue since it first joined with the Narragansett Indians, it's still using the same corporate strategy. That is why the company continues to focus its attention on Rhode Island.

Harrah's has grown over the past 10 years by trying to blanket the United States. The company has spent more than \$10 billion to acquire casino businesses across the country, giving it a foothold in places such as Mississippi, Indiana and Iowa to be as close as possible to its customers.

However, Harrah's has yet to break into the affluent and densely populated Northeast. The company's closest casinos to New England are in Atlantic City.

Consequently, Harrah's is spending significant time, money and effort backing the Narragansett Indians' push to bring a casino to West Warwick, even as the Nevada-based **company has turned toward international expansion.**

"Harrah's' strategy is different than a lot of casino firms," said Richard McGowan, an associate professor at Boston College's Carroll School of Management who studies gambling. "If you live in the continental U.S. you aren't more than 400 miles from a Harrah's-owed-or-operated casino."

But whether that close-to-the-customer strategy will stay in place for the next 10 years is unclear. Where does Harrah's go next?

Earlier this month, Apollo Management and Texas Pacific Group, two private-equity firms, offered to buy Harrah's for \$15.1 billion -- or \$81 a share. Harrah's appointed a special committee of its board to analyze the offer. The New York Times recently reported that the company's directors rejected the first bid, and the potential buyers have raised their offer to \$15.5 billion -- between \$83 and \$84 a share.

If the company is purchased by private entities, its growth plan could change, according to Rod Petrik, a gaming analyst with Stifel, Nicolaus & Company Inc., an investment firm.

Expansion over the past few years has left Harrah's with \$11 billion in long-term debt. Private-equity buyers such as Apollo and Texas Pacific typically borrow money to buy a company, which would saddle Harrah's with even more debt. Consequently, some of Harrah's development projects could be shelved and its "peripheral" properties could be sold to create cash flow to service that debt, said Petrik.

As of late last week, Harrah's still hadn't commented on a possible sale and it hadn't confirmed the higher bid.

In the meantime, Harrah's is still looking at expansion in Asia and Europe, said Jan L. Jones, senior vice president for communications and government relations. It also continues to be focused on expanding in the United States in places where gambling is being authorized, and reinvesting and growing in its existing markets to address competition.

The company has amassed a massive 350 acres on the Las Vegas Strip, and is in the midst of a \$550-million upgrade and expansion in Atlantic City.

Harrah's has acknowledged in its regulatory filings with the U.S. Securities and Exchange Commission that gambling competition is increasing in areas where the company is already operating and could "adversely affect" its financial performance.

"Clearly, one of the things for [Harrah's] to be successful is to continue to get new markets and to keep expanding," said McGowan.

HARRAH'S STARTED as a bingo parlor in Reno, Nev., in 1937. The company expanded into casinos in the 1950s and 1960s, and became a part of the Holiday Inn hotel chain in 1980, according to Hoover's Inc., a research firm. Spun off from the Holiday Inn chain in 1990, Harrah's expanded nationally in the 1980s and '90s, moving into riverboat gambling and Indian casinos.

In the mid-1990s, the company spent about \$900 million to open a casino in New Orleans, but at the end of the decade wrote off about \$39 million, due to a bad investment in National Airlines, according to Hoover's.

By 1998, Harrah's began an acquisition binge, buying Showboat Inc. for \$1 billion. In 1999, it purchased the Rio Hotel & Casino in Las Vegas for \$525 million. The following year, the company paid \$439 million for Players International and its casinos in Illinois and Missouri. In 2001, Harrah's purchased Harveys Casino Resorts' four casinos for \$712 million, according to a timeline on the company's Web site.

In 2004, the company bought Horseshoe Gaming Holding Corp. for \$1.45 billion, giving Harrah's control of casinos in Indiana, Mississippi and Louisiana.

Last year, the company completed its largest acquisition, the \$9.3-billion purchase of Caesars Entertainment. That expanded Harrah's presence in Las Vegas, adding 15 properties to its stable there, including Caesars Palace and the Paris casino.

"They had less of a concentration on the Strip than their peers. It's one of the reasons they bought Caesars," said Petrik.

The company now has 85,000 employees worldwide with casinos in the United States, Canada, Uruguay and on three cruise ships.

Much of the company's expansion has occurred under the direction of Gary Loveman, chairman, president and chief executive officer. Loveman, a former associate professor of business administration at Harvard University, is known for his marketing prowess, said McGowan.

Loveman was the company's chief operating officer from May 1998 to December 2002. He took over the role of Harrah's president in 2001, and chief executive officer in January 2003. He has been on the company's board of directors since 2000 and chairman since January 2005.

As part of Loveman's strategy of being close to customers, Harrah's also manages four casinos on Indian tribal lands.

It manages the Harrah's Prairie Band casino near Topeka, Kan., for the Prairie Band Potawatomi Nation. The company also manages the Harrah's Rincon casino for the Rincon San Luiseno Band of Mission Indians near San Diego, Calif.; the Harrah's Cherokee for the Cherokee Tribe in Cherokee, N.C.; and the Harrah's Ak-Chin for the Ak-Chin Tribe near Phoenix, Ariz.

In Rhode Island, the company has not made public the details of its arrangement with the Narragansett Indian Tribe for the proposed West Warwick casino. Rhode Island voters will be asked in a ballot question on Nov. 7 whether they want to amend the state's Constitution to allow for the casino.

In other states, under its management agreements, Harrah's makes minimum monthly payments to the tribes, according to its federal regulatory filings. Harrah's must pay the tribes even before it collects its management fee. If the operations don't generate enough cash to make this payment, Harrah's must make up the shortfall.

In some cases, the company has also guaranteed part or all of the debt the tribes took on to construct the casinos, according to regulatory filings. In return for guaranteeing the Indians' loans, Harrah's has a lien on the casino properties.

Indian casinos, though, are only a small portion of the company's business. Harrah's' annual revenue from its managed casinos and other operations, which include casino operations on cruise ships, a casino in Uruguay and the Indian casinos, is just 2.2 percent of the company's total annual revenue.

The revenue stream is smaller than the company's wholly owned casinos and Harrah's must adhere to federal guidelines regulating the tribes.

"Indian gaming is really restricted by the fact they are in a lot of Indian properties and the tribe has to be federally recognized," said Jones.

OVER THE COURSE of its expansion, Harrah's has become known in the industry for its success in attracting and keeping consumers.

The company is focused on promoting major, easily recognizable brand names such as Harrah's, Caesars and the World Series of Poker.

Leveraging the popularity of its brand names, the company has signed up 40 million participants in its Total Rewards loyalty program. Members can use their Harrah's Total Rewards cards at any Harrah's casino to earn points toward gambling, dining and entertainment at any other Harrah's destination. As of the end of 2005, the company had accrued about \$73 million to pay for anticipated loyalty credit redemptions.

On top of building customer loyalty, said Petrik, that system gives the company a large database of valuable consumer information. With it, Harrah's can put together highly targeted marketing campaigns that work to bring customers back again and again.

"They have the best technology systems, as far as tracking customers and customer play," said Petrik.

In addition, the company has worked to make its casinos familiar. Gamblers and customers know what they are going to get when they go to a Harrah's destination.

"They are like a McDonald's," said Petrik. "They have a franchise, they have standards and they deliver a consistent product, that's what branding is about."

From this consistent product, Harrah's generates a lot of cash, making it attractive to private investors. In 2005, the company had \$614.9 million in cash flow from its operations. And that was down 22.3 percent from 2004's \$791 million. Harrah's had to use some cash last year to pay off current liabilities from the Caesars acquisition, according to regulatory filings.

The company pours cash back into its businesses, making capital investments, pursuing business development opportunities and making acquisitions. In 2005, Harrah's spent \$1.2 billion on capital expenditures and expects to spend \$1.4 billion to \$1.5 billion in 2006, and that doesn't include spending for development opportunities such as the Rhode Island campaign.

"You reinvest to add amenities . . . to ensure an attractive environment for your guests," said Jones.

It's a strategic move to stay on top. Casinos are constantly expanding in an attempt to lure away competitors' customers.

Among other investments, Harrah's last year finished a 949-room, 26-story hotel and convention center at Caesars Palace in Las Vegas. In Iowa, the company's Bluffs Run Casino is undergoing an \$87-million expansion and renovation. Horseshoe Hammond in Chicago is undergoing a \$484-million upgrade to turn it into a 108,000-square-foot casino. Harrah's has already spent about \$29.2 million on its \$550-million expansion of Harrah's Atlantic City, where a 964-room hotel tower and a 172,000-square-foot retail and entertainment complex is being added.

"A competitor will have to build to that level, that's the reason for big expansion," said Bruce MacDonald, spokesman for the Mashantucket Pequot Tribal Nation, which owns the Foxwoods Resort and Casino in Connecticut. The Pequots are partnering with Harrah's rival, MGM Mirage -- the world's second-largest casino company -- to put the MGM name on a \$700-million expansion at Foxwoods.

Although Harrah's has been extremely successful at courting gamblers in its locations nationally, that could be a risk factor going forward, according to Petrik.

Competitors, such as MGM, are not just adding more gaming tables and slot machines to their facilities. They are adding convention centers, entertainment facilities, spas, luxury hotel rooms, restaurants and other non-gaming amenities.

Gambling is just 40 percent of competitors' revenue, said Petrik. "They drive the rest of their revenue by non-gaming sources."

For Harrah's though, "When you're in non-Vegas markets -- particularly Indiana, Illinois, Mississippi -- you're not generally seeing ancillary revenue."

And being in diversified locations requires dealing with additional gaming regulations from a variety states, which can be time-consuming and impact profit if gaming taxes rise, said McGowan.

"Sometimes they overplay their hands on the public-policy process and are heavy-handed in pushing through the tax rate," said McGowan.

International expansion is also providing another hurdle for Harrah's.

The company recently dropped out of the race to gain a license in Singapore -- a hot international gaming location -- due to high costs. However, the company late Friday boosted its offer to \$570 million from \$521 million to purchase London Clubs International, a casino operator that runs facilities in London, South Africa and Egypt.

The biggest question mark for Harrah's, though, is the possible purchase by private investors.

Shareholders sent the stock down this summer to a 52-week low of \$59.05 after a 52-week high of \$82.33 a share in May. They were concerned that the company's aggressive expansion may not translate into greater growth and profitability, said Robert LaFleur, gaming analyst with Susquehanna Financial Group, a Pennsylvania-based financial-services firm. Since the buyout offer, the stock has rebounded. Harrah's (HET:NYSE) stock closed Friday at \$73.96 on the New York Stock Exchange.

"I know the large shareholders are very frustrated with the shares and the stock," said LaFleur.

In expanding, the company's long-term debt has more than tripled in three years. In addition, the net profit margin for Harrah's was 3.3 percent last year. In comparison, MGM's net profit margin was 6.84 percent.

Large shareholders may want to push forward with a sale to private buyers and collect a premium for their stock, rather than wait to see if the management team can turn expansion into sustained profitability growth, said LaFleur.

And if a private-equity buyout goes forward, Harrah's may need to curtail expansion or sell properties to generate cash to service additional debt that private buyers may take on to purchase the company, say analysts following the industry.

"Everything that's not fully committed to do at this point," could be dropped to generate cash flow, said LaFleur.

Regardless of the pending buyout offer, Harrah's says it is committed to backing the Narragansetts' casino proposal through the election. Over the past four months the company has spent close to \$8.4 million on the casino campaign. And Loveman, the company's president and chief executive officer, was in Rhode Island on Wednesday to debate anti-casino forces.

Although Loveman continues to move forward with his expansion strategy for Harrah's, it's impossible to control what Rhode Island voters will do on Nov. 7 and even more importantly, it's unclear what will happen with the private-equity offer.

In Rhode Island, at least the company will have an answer to its casino push in 17 days.

The private-equity bid, however, will take more time. With large shareholders pushing for greater returns, said LaFleur, the board may decide it's time to sell.