U.S. Gaming Revenue Trends

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An Executive Summary Prepared by:

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INTRODUCTION

Casinos in Atlantic City dropping like flies.

Two casinos in Mississippi shutting their doors.

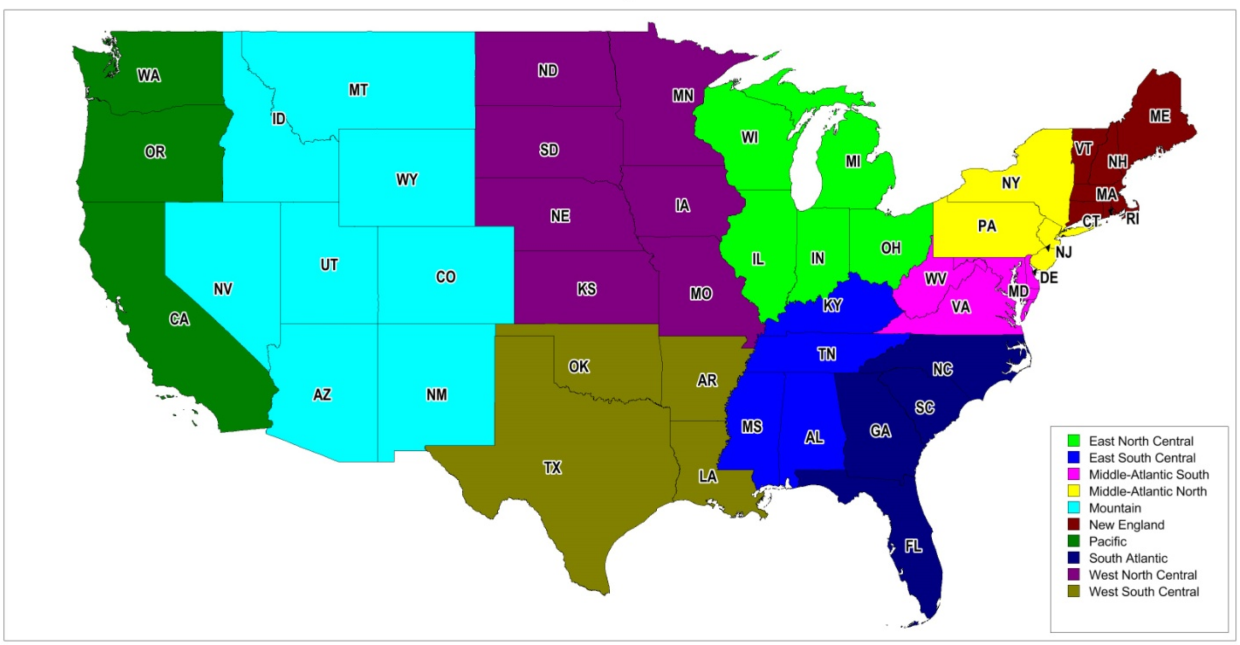
Regional markets across the nation flat to declining.

Isn’t the recession over?

To understand why the economy is headed in one direction and gaming performance in the other, the Innovation Group has conducted a nationwide consumer survey and trend analysis. The trend analysis examined regional gaming revenue, income and employment, age demographics, and consumer sentiment and preferences.

The analysis covers the following Census regions:

Census Regions



The analysis resulted in the following conclusions:

- Elasticity remains below pre-recession levels and participation rates have declined, particularly in the 55 and over age cohort.

- Growth on the Las Vegas Strip accelerated in 2013; however, conditions remain sluggish in the balance of Nevada and other regional markets.

- Adding new geographies or expanding undersupplied markets has led to market growth.

- However, with reduced elasticity, mature markets have been flat or declining and existing facilities are more sensitive to new competition.

- Household income grew a meager 0.43% in 2013, the first upward tick since 2007, and remains well below pre-recession levels. Consumer sentiment remains weak although the trend is positive.

- The employment number has recovered to pre-recession levels, but the concomitant increase in the working age population has not been absorbed. This surplus in the labor force has kept wages low.

- Trends in demographics and consumer preferences are not favorable either, especially with slot product that fails to attract younger customers. Population growth is strongest at the two ends (young adults and seniors) and weakest in the middle. While seniors have been the mainstay of the regional markets, it is an open question whether the Baby Boomers in retirement will participate in gaming to the same extent as the Greatest Generation.

- Spending on “Location-Based Entertainment” has shrunk, with more than 80% of consumer expenditures on entertainment now going to “Audio and Visual Equipment and Services” and “Cell Phone Services.”

REGIONAL MARKET REVENUE

The following table shows gaming revenues in the past five years for markets divided into census-designated regions.

Regional Gaming Revenues (MMs)[1]

	2009	2010	2011	2012	2013	5-Year CAGR	2012-2013 Change
East-North Central	$8,094	$8,148	$8,207	$8,908	$9,145	3.1%	2.7%
East-South Central	$2,410	$2,336	$2,197	$2,232	$2,122	-3.1%	-4.9%
Mid-Atlantic Total	$9,402	$9,688	$10,306	$10,909	$10,982	4.0%	0.7%
Mid-Atlantic North	*$7,924*	*$8,195*	*$8,650*	*$9,069*	*$8,992*	*3.2%*	*-0.9%*
Mid-Atlantic South	*$1,478*	*$1,493*	*$1,656*	*$1,840*	*$1,990*	*7.7%*	*8.1%*
Mountain[2]	$8,905	$8,692	$8,817	$9,011	$9,005	0.3%	-0.1%
New England	$2,692	$2,598	$2,585	$2,472	$2,402	-2.8%	-2.8%
Pacific	$9,330	$9,316	$9,536	$9,706	$9,770	1.2%	0.7%
South Atlantic[3]	$2,265	$2,450	$2,539	$2,639	$2,742	4.9%	3.9%
West-North Central	$5,282	$5,335	$5,489	$5,817	$5,714	2.0%	-1.8%
West-South Central	$6,021	$6,124	$6,433	$6,771	$6,940	3.6%	2.5%
Regional Total	$54,401	$54,687	$56,109	$58,465	$58,821	2.0%	0.6%
Las Vegas Strip	$5,550	$5,777	$6,069	$6,207	$6,508	4.1%	4.8%
Remainder of Nevada[4]	*$4,838*	*$4,628*	*$4,624*	*$4,648*	*$4,637*	*-1.1%*	*-0.2%*
Grand Total	$59,951	$60,464	$62,178	$64,672	$65,330	2.2%	1.0%

Source: The Innovation Group

Notes: 1. Does not include all Native American Markets; 2. Excluding LV Strip; 3. Florida only, revenue for North Carolina is not available; 4. Included in Mountain Regional

Regional markets increased by just 0.6% in 2013, with decreases in five census regions. For the five regions experiencing growth, the following table provides commentary:

Market	Growth	Comment
East North Central	2.7%	New Jurisdiction: Ohio
Mid-Atlantic South	8.1%	New Jurisdiction: Maryland
Pacific	0.7%	Slight growth, still below pre-recession level
South Atlantic	3.9%	Ramping up of Florida
West South Central	2.5%	Normative growth in Oklahoma; ramp up in Arkansas; 2 new casinos in Louisiana

To assess the role of cannibalization versus economic and consumer factors, we compared trends in a number of census regions and gaming markets. Evidence suggests that while cannibalization is undeniably a large contributor to declines in a number of markets, economic factors continue to play a role in sluggish revenue trends. In fact, economic and consumer factors are believed to be hindering market elasticity and exacerbating the impacts of new competition on adjacent markets.

Cannibalization and Market Saturation

As an example of cannibalization, we can look at the Great Lakes, or what the Census terms East-North Central, comprised of Illinois, Indiana, Michigan, Ohio, and Wisconsin. The following table provides a breakdown of gaming revenues across the states within this region.

East-North Central Gaming Revenues

	2009	2010	2011	2012	2013	5-Year CAGR	2012-2013 Change
East-North Central							
Illinois	$1,428.9	$1,370.9	$1,380.4	$1,638.2	$1,551.3	2.1%	-5.3%
Indiana	$2,798.2	$2,801.6	$2,732.8	$2,685.5	$2,466.7	-3.1%	-8.1%
Michigan	$2,633.6	$2,768.5	$2,897.0	$2,938.6	$2,854.7	2.0%	-2.9%
Ohio				$429.8	$1,070.4		149.0%
Wisconsin	$1,233.3	$1,206.5	$1,196.4	$1,215.5	$1,202.2	-0.6%	-1.1%
East-North Central Total	$8,094.0	$8,147.6	$8,206.7	$8,907.6	$9,145.4	3.1%	2.7%

Source: The Innovation Group; $Millions

With the addition of a new jurisdiction, Ohio, total revenue in the region increased. However, the impact of Ohio can be clearly seen in the dramatic decline in Indiana, most of which occurred in the Southeast Indiana market bordering the Cincinnati area. Moreover, factoring out Michigan's Native American casinos, which do not significantly overlap the Ohio market, the commercial Michigan market (Detroit) suffered a 4.7% decline in 2013. Ohio also impacted Western Pennsylvania, which had a 3.9% decline as discussed previously.

Mature Markets Isolated from New Competition

To isolate the impacts of new jurisdictions and their cannibalization from economic and consumer factors, we assessed trends in selected markets that have not had major expansions and that were insulated from new competition. The fact that these insulated markets have also experienced revenue declines indicates that the economy is still playing a role in sluggish conditions.

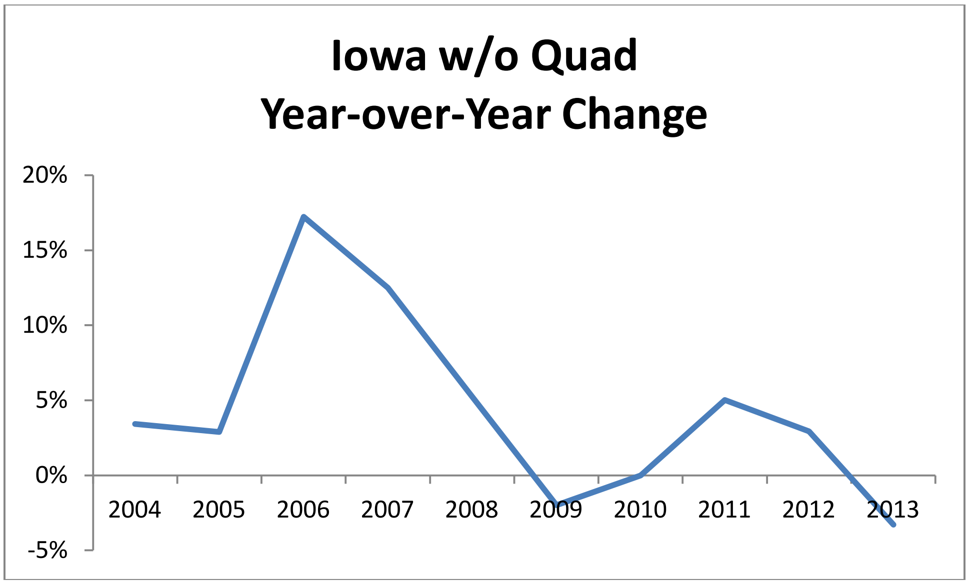
As noted previously, the West-North Central region declined in 2013, despite not being impacted by new competition in adjacent states. We also examined selected markets such as Iowa, which with the exception of the Quad Cities has been relatively unaffected by developments in adjacent states. There has been one new casino opening, the Grand Falls Casino Resort in Larchwood, which opened in 2011 and primarily targets Sioux Falls, South Dakota. Grand Falls brought revenue growth to Iowa in 2011 and 2012; however, statewide revenue declined by 3.5% in 2013. Excluding the Quad Cities casinos (Bettendorf and Davenport), which have faced specific operational issues as well increasing competition in Illinois first from a new Casino Rock Island property and then from VGTs, Iowa revenue declined by 3.3%.

Iowa Gaming Markets

	2009	2010	2011	2012	2013	5-Year CAGR	2012-2013 Change
Iowa w/o Quad Cities							
Ameristar II	$144.4	$146.7	$155.6	$156.2	$150.2	1.0%	-3.8%
Catfish Bend	$34.8	$34.5	$35.4	$35.8	$34.7	0.0%	-3.1%
Diamond Jo Dubuque	$64.5	$63.0	$64.0	$63.6	$58.3	-2.5%	-8.3%
Diamond Jo Worth	$72.7	$74.1	$80.5	$84.3	$80.2	2.5%	-4.8%
Grand Falls Casino Resort			$27.9	$49.5	$50.0		1.1%
Harrah's Council Bluffs	$82.9	$74.4	$64.0	$62.9	$64.0	-6.3%	1.8%
Isle Casino Waterloo	$67.1	$73.7	$76.0	$77.8	$77.8	3.8%	0.0%
Lady Luck	$29.0	$28.0	$28.7	$28.8	$27.7	-1.1%	-3.9%
Lakeside	$46.3	$45.7	$46.7	$47.3	$47.3	0.5%	-0.1%
Riverside	$77.3	$77.3	$81.0	$80.5	$79.6	0.8%	-1.1%
Wild Rose-Clinton	$37.0	$37.6	$38.1	$36.9	$33.5	-2.5%	-9.3%
Wild Rose-Emmetsburg	$25.7	$26.7	$29.2	$30.2	$29.7	3.7%	-1.5%
Horseshoe Casino	$162.0	$165.0	$170.8	$172.6	$168.0	0.9%	-2.7%
Mystique Casino	$58.2	$56.1	$55.4	$54.2	$51.1	-3.2%	-5.8%
Prairie Meadows	$172.6	$171.4	$174.8	$180.7	$171.0	-0.2%	-5.4%
Iowa Subtotal	$1,074.4	$1,074.2	$1,128.2	$1,161.3	$1,123.2	1.1%	-3.3%
Quad Cities							
IOC Bettendorf	$76.7	$73.3	$72.3	$70.9	$68.1	-2.9%	-3.8%
Rhythm City Davenport	$54.2	$51.1	$47.0	$48.6	$44.0	-5.1%	-9.5%
Quad Cities Total	$130.9	$124.4	$119.2	$119.5	$112.1	-3.8%	-6.1%
Grand Total	$1,205.3	$1,198.6	$1,247.4	$1,280.8	$1,235.3	0.6%	-3.5%

Source: The Innovation Group; $Millions

The following chart clearly shows the impact of the recession, which hit Iowa later than the rest of the country. After growth in 2011 and 2012 from the Grand Falls Casino, the trend reverted in 2013 to its 2009 and 2010 picture. It should be noted that these reported revenues include free play, which has been increasing in recent years. The trends net of free play are likely even worse; however, it is not possible to isolate the value of free play in Iowa. Free play is taxed in Iowa and lumped in with gross revenue.

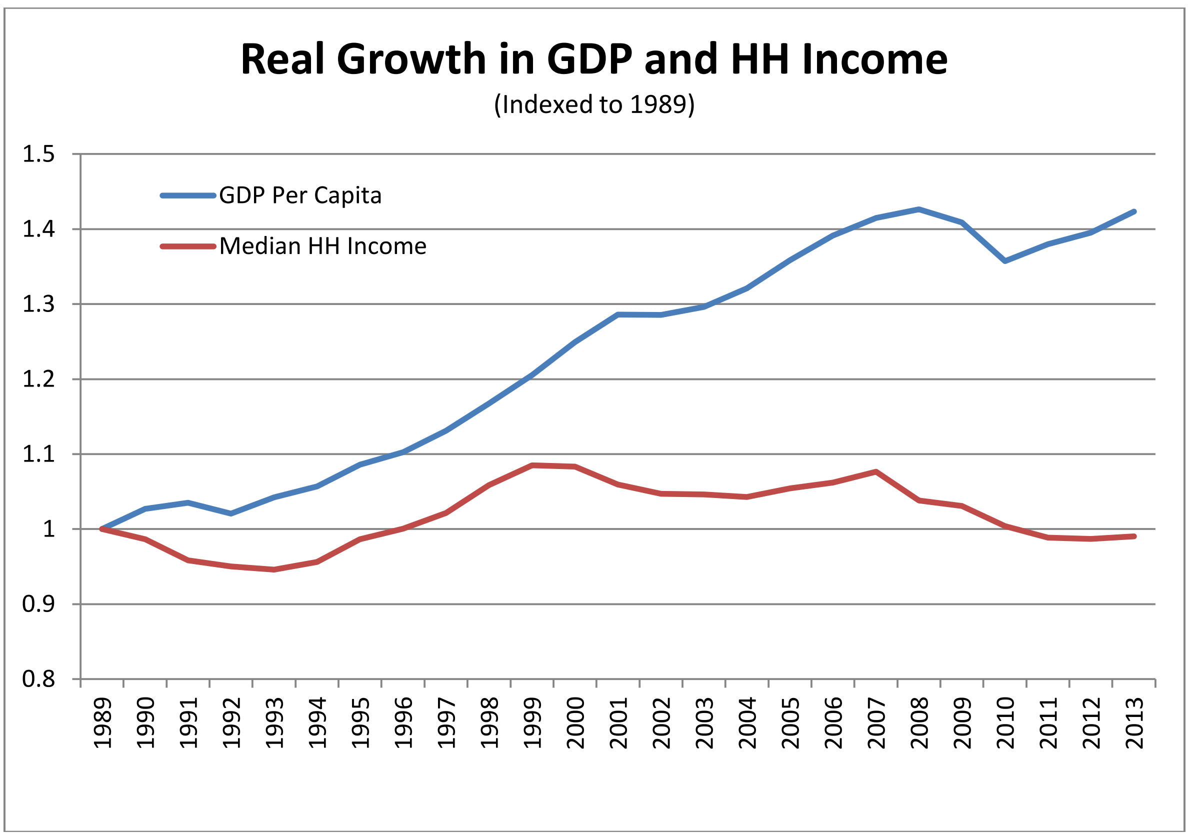


Economic Trends

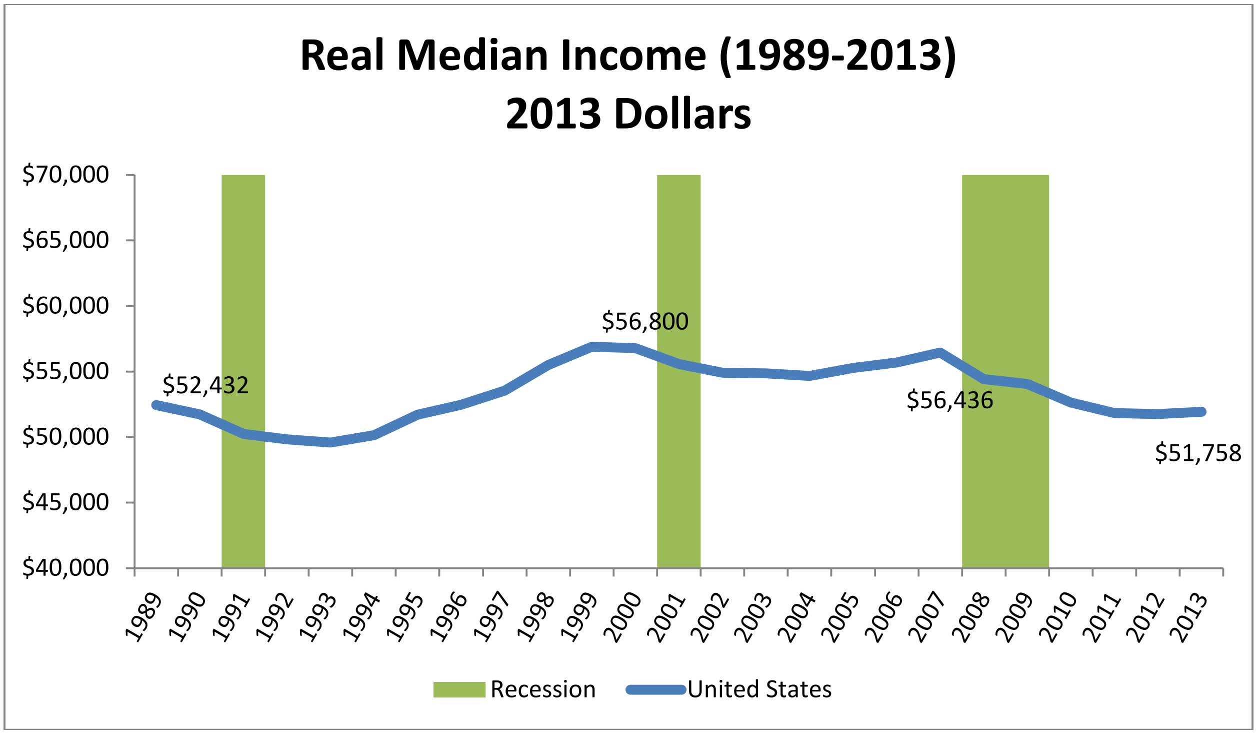
The gaming industry has been known to be heavily impacted by the state of the economy. Unemployment rates, household income, and discretionary income drive the way people feel about the economy, which is reported in the consumer sentiment index. Plainly said, people tend to tighten their purse strings when unemployment is high and household income is low. This section outlines how these effects of the economy have potentially caused gaming revenue to decline in the United States.

Household Income

During the past decade household income lagged far behind gains in productivity. The widening gap in the following chart illustrates that American households effectively have not been earning enough to purchase the goods and services they have been producing. Consumer expenditures on gaming and other leisure activities remained strong into 2007 largely on the basis of rising home values; however, gaming revenues started a steady and pronounced decline once the housing bubble burst and the financial sector collapsed. Although 2013 saw a slight uptick in real income (0.35%), the first since 2007, GDP grew by over 2%, thereby increasing the gap.



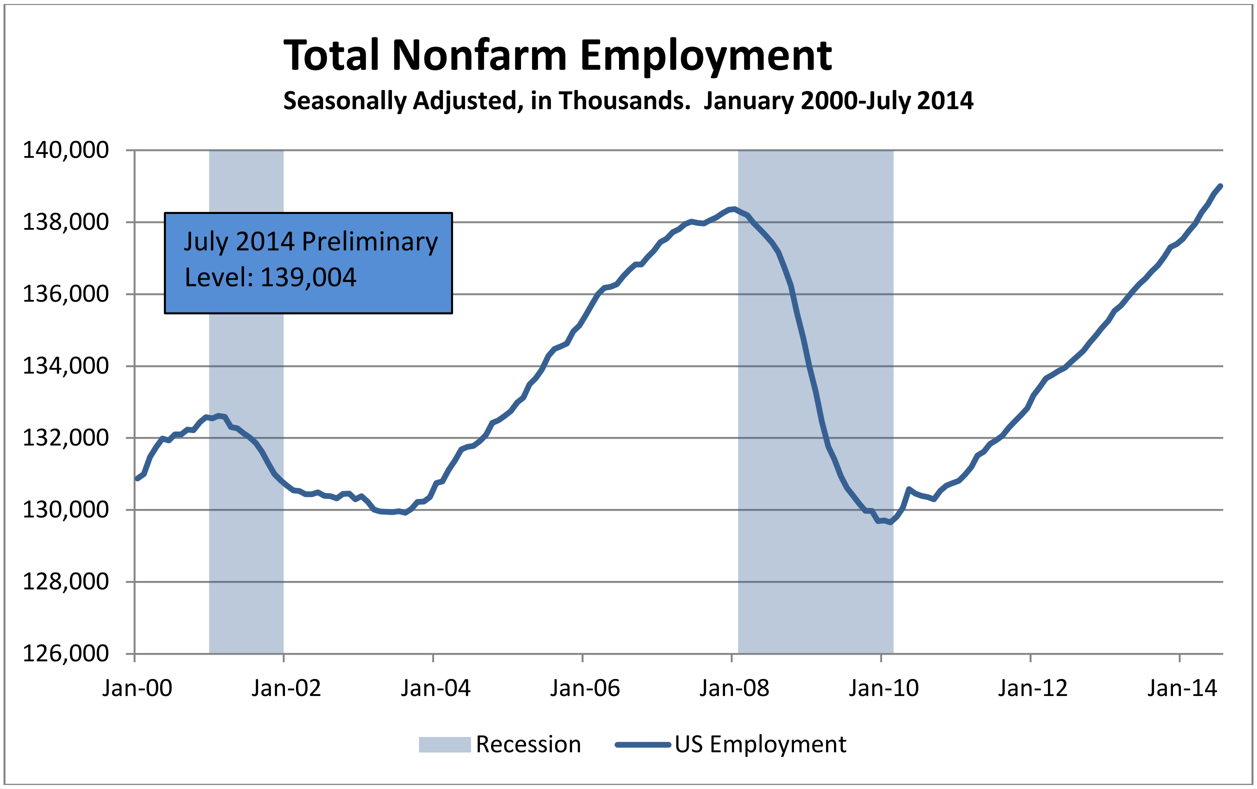
In fact, national median household income is lower than it was 25 years ago (in constant 2013 dollars). Even before the recession hit in 2008, real median income was lower than it had been in 1999 and 2000, as incomes declined in 2001 through 2004.



Source: US Census Bureau, Current Population Survey, 1967-2013,Annual Social and Economic Supplements

Labor Force and Employment

In terms of employment the Great Recession began at the national level in February 2008, with employment peaking in January 2008. Since then, the U.S. suffered 24 months of declining employment; during the five month period of November 2008-March 2009 the average monthly decline was 604,000. Employment bottomed out in February 2010 at a low of 129.3 million. Since then it has steadily grown, and now stands at 139,000, slightly above (0.48%) its pre-recession peak. However, the working age population has grown by 6% over the same period.



Source: Bureau of Labor Statistics, CES series; most recent month data is preliminary

Looking at the census regions for 2013, employment and labor force increased in every region except East South Central and New England regions. These markets, with the addition of the Mid-Atlantic North region, experienced a decline in the overall labor force.

Change in Employment (2012-2013)

	Employment	Labor Force
East North Central	0.4%	0.3%
East South Central	-0.7%	-1.0%
Mid-Atlantic North	0.8%	-0.1%
Mid-Atlantic South	0.6%	0.2%
Mountain	1.2%	0.3%
New England	-0.1%	-0.2%
Pacific	1.6%	0.1%
South Atlantic	1.6%	0.2%
West North Central	0.9%	0.5%
West South Central	1.6%	1.2%
Total	1.0%	0.2%

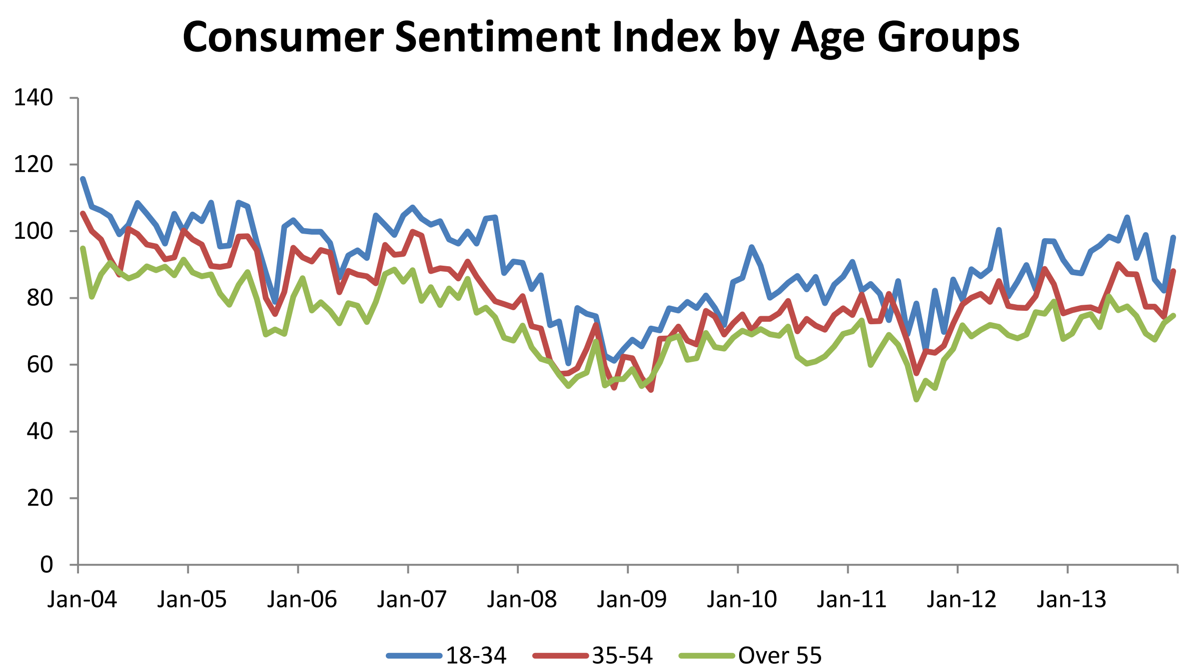
Source: The Innovation Group; BLS

Despite the general improved employment picture, income gains have lagged far behind. As noted above, there is a 5.5% gap between employment growth and population growth (employment up by 0.48% over pre-recession level compared to 6% growth in the working age population). This continuing surplus has tended to keep wages low.

Consumer Sentiment

The consumer sentiment index is created and published monthly by The University of Michigan. The index is normalized to have a value of 100 in December 1964, and utilizes at least 500 telephone interviews from across the United States.

As can be seen in the chart below, all age groups tend to have similar outlooks on the economy over time. Seniors, however, tend to have more of a pessimistic outlook than the younger demographics. This is likely primarily due to the close proximity to retirement, and the need to save additional money. This population has also seen equity built up in their homes disappear during the recent recession which hit across the nation. Additionally, many of these seniors are already unemployed as they lost their jobs during the recession and, as the economy has recovered, employers are going with younger and cheaper labor; without jobs and a full 401k, discretionary income is minimal.



The Pew Research Center in January 2014 found that the percentage of people who call themselves middle class has decreased by one fifth from 53% to 44% since 2008. Now, 40% of people identify themselves as either lower middle or lower class as compared to 25% in 2008. Gallup discovered Americans who said they were middle to upper-middle class fell eight points during 2008-2012 to 55%. Peoples' wallets have been constrained and discretionary spending is down due to weak wage growth, tight credit, and increasing mortgage prices.

DEMOGRAPHICS AND CONSUMER BEHAVIOR

The age mix of a region's population can have a large impact on the casino volume that drives revenues. Not only does the desire to gamble vary by age, but also the gaming preferences of different patrons. Without the evolution of gaming product, many people within the younger demographic are not attracted to casino properties. This section examines the demographics of each region individually as well as how gaming products have evolved, and will continue to evolve, in order to attract target age groups.

Demographics

A potential cause of the decline in gaming revenues is a major shift in the demographics living within the varied casino markets selected for our analysis. As can be seen in the chart below, for all regions growth is strongest at the two ends (younger and older cohorts) and weakest in the middle, which is a prime gambling cohort. At least as far as local/regional casinos are concerned, the young cohort has traditionally been the least likely to visit casinos. As a group, the cohort typically has other entertainment interests and less disposable income.

Casino Market Demographic Changes (2000-2014)

	Young Adults (21-34)	Middle Aged (35-54)	Seniors (55+)	Overall Population
East North Central	-0.1%	-0.6%	2.2%	0.5%
East South Central	0.3%	0.0%	2.4%	0.9%
Mid-Atlantic North	0.2%	-0.4%	1.9%	0.5%
Mid-Atlantic South	0.7%	0.0%	2.9%	1.1%
Mountain	1.4%	0.9%	3.7%	1.9%
New England	0.1%	-0.5%	2.3%	0.6%
Pacific	0.7%	0.4%	3.1%	1.3%
South Atlantic	1.0%	0.8%	3.0%	1.6%
West North Central	0.7%	-0.4%	2.3%	0.8%
West South Central	1.2%	0.8%	3.0%	1.6%
United States	0.6%	0.1%	2.6%	1.1%

Source: iXpress; The Innovation Group

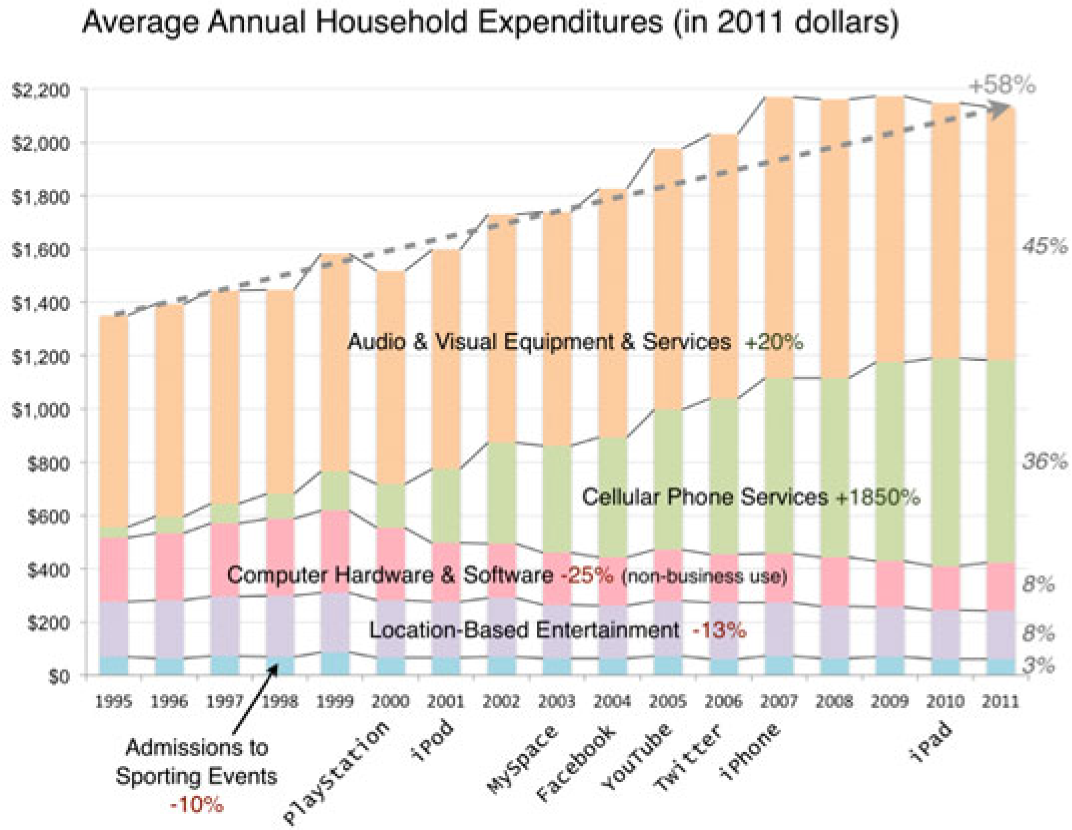
The oldest cohort has traditionally been the single largest market for local and regional casinos. Some casinos generate up to 65% of revenues from this cohort. Why gaming revenue has declined at a time when this cohort is going the fastest of all adult cohorts is striking. The recession had a huge impact on home values and retirement accounts, which led many older adults to worry about their retirement security despite the slowly improving economy. According to a Pew Institute study, 63% of workers ages 50-61 say they may need to postpone expected retirement. Another Pew Institute study found 38% of adults surveyed said they were "not too" or "not at all" confident that they will have enough income and assets for retirement. Approximately 34% of adult ages 60-64 express little confidence in retirement assets. Moreover, it is worth considering whether the Baby Boomers in retirement will participate in gaming to the same extent as their parents have.

Entertainment Spending

Overall spending on entertainment has dipped slightly since its pre-recession peak, according to White Hutchinson Leisure and Learning Group, which has access to detailed unpublished data from the U.S. Bureau of Labor and Statistics' Consumer Expenditure Survey (CEX). What is even more notable than the slight overall decline is the distribution of spending.

White Hutchinson's 2012 study on the long-term trends of American entertainment spending looked at the five following categories: Location Based Entertainment, Admissions to Sporting Events, Audio and Visual Equipment and Services, Cellular Phone Service, and Computer Hardware and Software for non-business use.

From 1995 to 2011, total household entertainment increased by 58%. This growth, however, is entirely generated from mobile electronic and in-home entertainment. The study shows electronic entertainment spending has increased at the expense of location-based entertainment, which has decreased by 13% from 1995-2011.



As the gaming industry continues to evolve, social media and online gaming are projected to become increasingly competitive with the casino industry. At the East Coast Gaming Congress, Cordish Entertainment noted that Facebook, Google, and Apple are potentially the gaming industry's largest long-term competitor. Specifically, social games that involve the purchase of virtual currency are seeing a rise in popularity. These types of games can be used as a gateway to the younger middle aged group, as they are the most likely to spend money while playing. If regulations ever remove the traditional barriers of entry to the gaming industry, these companies could possibly compete and build gaming apps. Gaming apps are more convenient as they have access to people's homes providing a broader market than the typical regional facility. Further exploration would determine how to use these gateways to drive the younger middle aged demographic to land-based gaming.

Gaming Product Evolution

A major challenge to attracting a new generation of casino gamers has been in slot machine development. Casino Enterprise Management points out that Generation Y, or Millennials, prefer interactive games where players compete against each other rather than a machine or system.[1] Millennials have a strong sense of community on a local and global scale due to technological advances in communication. The typical young casino visitor avoids the banks of slot machines and goes primarily to the tables or to non-gaming amenities such as bars and clubs. Turning this demographic into slot players will require creating an enticing casino habitat that redefines gaming. The significance of converting young table players into machine players was noted at this year's Southern Gaming Summit by Golden Nugget owner Tilman Fertitta, who pointed out the simple fact that profit margins on slots are a lot higher. Moreover, in regional casinos slot revenue typically accounts for between 75% and 90% of total gaming revenue.

Creating a skill element for slot machines would not be unthinkable; many large slot manufacturers already are involved with both types of gaming, such as Bally Technologies and Konami Corporation. Furthermore, the younger demographic is spending large sums of money, on video games if not slot machines. Gartner Research reported worldwide video game sales in 2012 of $93.2B including mobile games, PC and console games, and others. At G2E 2014, David Chang of Gamblit Gaming LLC pointed out that Millennials "are already commanding an estimated US$1.3 trillion annual in direct purchasing power… I think you [the casino industry] would be wise to start looking at this demographic and paying attention."[2]

However, designing and implementing a skills-based slot machine has been hampered by regulatory and technological challenges. How to reward skill when results are required to be random generated? Early attempts of skill-based games only gave the illusion of skill. Even with the latest advancements, in games displayed at G2E 2014, mastering a skill does not result in a prize, it only gives the player a chance to spin a reel or roll virtual dice.

[1] "Casino Designs for a New Generation," February 2013.
[2] http://www.ggrasia.com/icymi-here-come-the-millennials/

Overcoming these technical challenges, moreover, may not turn Millennials into slot players, at least in the short term, although it may be a pre-condition for capturing them when they turn 40. As Aristocrat CEO Jamie Odell noted at G2E, the Australian liquor industry spent years trying to get young people to drink wine: "Eventually the industry worked out they all do – but not until they're 30."[3]

Another effort to diversify revenue streams and tap into technology trends has also proved disappointing to date. Three states have turned to iGaming, which aims to capture revenues from patrons that prefer to play in the comfort of their own home rather, in hopes of capitalizing on the "next big thing" for the casino industry. Unfortunately, iGaming revenues have been well-below projections in Nevada, New Jersey, and Delaware. New Jersey officials, for example, forecasted annual iGaming tax revenues of $180 million. At the current run rate, the state is on track to realize only one-tenth of that, or $18.8 million. Gross gaming revenue from iGaming is on track to reach just $125 million for the year.

[3] *IBID*

CONCLUSION

Implications for Gaming Participation Rates

With employment and incomes lagging well behind population growth, by implication gaming propensity must necessarily be reduced. As the un- or underemployed drop out of the gaming market or reduce frequency while the population increases, the percentage of the gaming age population that visits a casino has declined. This trend is exacerbated by changing age demographics and consumer preferences.

A survey conducted by Penn National Gaming Inc (PENN) in 2014 would tend to support the hypothesis of declining participation rates. The survey assessed 2,000 customers who have gambled at their properties two or more times in the past two years. Survey respondents were split into two segments: those with win per visits above and below $100. Results of this survey found trip frequency has decreased and spend per trip is flat for both segments, resulting in a reduced annual spend. Players who typically spend an average of less than $100 per visit have seen the largest impact from the economy. The study also found that the below $100 segment tends to not be full time employees (a significant portion being retirees) who currently have significant obligations of paying off large items such as cars and homes, financed in the past few years (as per PENN's survey).

A New Normal?

A remaining question is whether these gaming participation trends are temporary or whether they represent a new normal. The economic trends would tend to support optimism, albeit one with disclaimers.

Recent employment gains have exceeded working-age population growth, but the job deficit created by the economy of the 2000s remains more than 10 million. At the end of 2000, the ratio of employment to the population aged 18-65 was 76%. This bottomed out at 68% in 2010 but has recovered to 70% as of July 2014. At current rates of employment growth, the 76% ratio would be largely restored within five years.

However, wage and income trends have not been as favorable, and there is little evident prospect of a change, given the decades-long trend of the weakening of labor bargaining power. Moreover, counter-productive austerity politics remain ascendant in Europe and to a lesser extent the United States, which does not bode well for a sustained global economic recovery.

Consumer trends are even less favorable, unless land-based gaming can figure out how to ride the wave of technology and the virtual world. Skills-based slot machines are not likely by themselves to prove a panacea, at least in the near term.

Casino gaming is not likely to go the way of bowling leagues, bingo, and horse racing. However, it is at least worth considering what "normative" or "organic" growth will mean in the coming years. Nationwide gaming revenue will grow as new geographies open, such as in

Massachusetts and New York. However, the days of expecting 2.5% or 3.0% annual growth in mature markets may be over for the foreseeable future.