Methodology

Rating Companies in the Gaming Industry

NOVEMBER 2014
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Scope and Limitations

This methodology represents the current DBRS approach for ratings in the gaming industry. It describes the DBRS approach to credit analysis, which includes consideration of historical and expected business and financial risk factors as well as industry-specific issues, regional nuances and other subjective factors and intangible considerations. Our approach incorporates a combination of both quantitative and qualitative factors. The methods described herein may not be applicable in all cases; the considerations outlined in DBRS methodologies are not exhaustive, and the relative importance of any specific consideration can vary by issuer. In certain cases, a major strength can compensate for a weakness and, conversely, a single weakness can override major strengths of the issuer in other areas. DBRS may use, and appropriately weight, several methodologies when rating issuers that are involved in multiple business lines. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Introduction to DBRS Methodologies

- DBRS publishes rating methodologies to give issuers and investors insight into the rationale behind DBRS's rating opinions.
- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. DBRS ratings assess an issuer's ability to make timely payments on outstanding obligations (whether principal, interest, preferred share dividends or distributions) with respect to the terms of an obligation. In some cases (e.g., non-investment grade corporate issuers), DBRS ratings may also address recovery prospects for a specific instrument given the assumption of an issuer default.
- DBRS operates with a stable rating philosophy; in other words, DBRS strives to factor the impact of a cyclical economic environment into its ratings wherever possible, which minimizes rating changes due to economic cycles. Rating revisions do occur, however, when more structural changes, either positive or negative, have occurred, or appear likely to occur in the near future.
- DBRS also publishes criteria that are an important part of the rating process. Criteria typically cover areas that apply to more than one industry. Both methodologies and criteria are publicly available on the DBRS website, and many criteria are listed below under “Rating the Specific Instrument and Other Criteria.”
Overview of the DBRS Rating Process

• There are generally three components to the DBRS corporate rating process: (1) an industry risk rating (IRR), (2) an issuer rating and (3) considerations for specific securities. The figure below outlines this process.

• An IRR is a relative ranking of most industries that have a DBRS methodology, typically using just three ranges of the DBRS long-term debt rating scale (i.e., “A,” BBB and BB), without making use of the “high” or “low” descriptors. The IRR is a general indication of credit risk in an industry and considers, among other things, an industry’s (1) profitability and cash flow, (2) competitive landscape, (3) stability, (4) regulation and (5) other factors. An “industry,” for the purposes of the IRR, is defined as those firms that are generally the larger, more established firms within the countries where the majority of DBRS’s rated issuers are based; this remains true for DBRS methodologies that are more global in nature. The industry risk rating helps DBRS set the business risk rating (BRR) grid (see below) in that it positions, in an approximate way, an average firm in the industry onto the BRR grid. For firms in industries with low IRRs, the IRR can, in effect, act as a constraint or “cap” on the issuer’s rating.

• The issuer rating is DBRS’s assessment of the probability of default of a specific issuer. It is a function of (1) the BRR, determined by assessing each of the primary and (where relevant) additional BRR factors in the BRR grid for a specific issuer; and (2) the financial risk rating (FRR), determined by assessing each of the primary and (where relevant) additional FRR metrics. The two components, BRR and FRR, are combined to determine the issuer rating; in most cases, the BRR will have greater weight than the FRR in determining the issuer rating. Throughout the BRR and FRR determination process, DBRS performs a consistency check of the issuer on these factors against the issuer’s peers in the same industry.

• The issuer rating is then used as a basis for specific instrument ratings. DBRS assigns, for example, a recovery rating and notches up or down from the issuer rating to determine a specific instrument rating for instruments of non-investment grade corporate issuers. (See “Rating the Specific Instrument and Other Criteria” below.)

DBRS Rating Analysis Process

* Depending on the instrument, “other criteria” may include the recovery methodology for non-investment grade issuers or the preferred share and hybrid criteria, for example. Please refer to the section below entitled “Rating the Specific Instrument and Other Criteria” for a list of these criteria, as well as other criteria that may be applicable at any stage of the rating process.
Gaming Industry

- The gaming industry is defined to include companies principally involved in housing and accommodating various types of gaming activities. This methodology is broadly applied to all operators in the gaming industry, despite significant differences between the companies’ business models and product offerings.
- Per the three-tier industry risk rating system described on the previous page, the gaming IRR is BB.
- The gaming industry is characterized by (1) higher-than-average competition, although such competition may be mitigated to some extent by regulatory barriers to entry where licensing requirements are extensive; (2) higher-than-average industry volatility, in line with changes in consumer discretionary income; (3) varying degrees of involvement from government entities and/or aboriginal communities; and (4) regulations that can be mild to extensive, depending upon the jurisdiction.
- Asset quality and market share are important factors in driving the operator’s profitability, each of which require large investments in advertising and promotion if any meaningful market share is to be obtained. Casino operators with higher asset quality (i.e., newer or recently renovated amenities), combined with high-quality hotel and dining options, are more likely to gain access to higher customer traffic and leading market share.
- Regulatory environments can vary across jurisdictions, potentially with substantial impact on casino operators. Key considerations may include restrictions and limitations on new entrants, causing high barriers to entry; changing societal values, causing loosening or tightening government regulations on gaming; growth in gaming as a source of government tax income; and unfavourable initiatives leading to increased taxation on casino operators.
- Gaming operators with more of a local clientele may be more adverse to economic downturns relative to casino operators in tourism destination areas (e.g., Las Vegas or Macau).
- Properties with hotels, dining options and entertainment venues have a greater ability to attract higher customer traffic.
- Geographic diversification of casino locations can offset swings in regional economic conditions and provide access to growing markets.
- Gaming operators of aboriginal ownership generally exhibit a higher level of market concentration and corporate governance risks, as well as limited asset collateral value in the event of default. In some cases, this is partially offset by preferential government legislative policies.
- Cash flow from gaming operators is often strong, although this may be partially offset by relatively high capex needs over the long term.
- Gaming operators may also face increasing competition from the online gaming sector.
Gaming Business Risk Rating

PRIMARY BRR FACTORS
• The BRR grid below shows the primary factors used by DBRS in determining the BRR. While these primary factors are shown in general order of importance, depending on a specific issuer’s business activities, this ranking can vary by issuer.

Gaming – Primary BRR Factors

<table>
<thead>
<tr>
<th>Rating</th>
<th>Government Regulation/Competition</th>
<th>Location</th>
<th>Asset Quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Regulatory environment supportive of incumbent’s market position, which creates a high barrier to entry and limited competition.</td>
<td>Located in markets with extremely favourable and sustainable economic conditions (i.e., large populations and densities, low unemployment rates, high disposable income and strong population growth potential).</td>
<td>Properties are new/recently renovated, high-quality assets.</td>
</tr>
<tr>
<td>BBB</td>
<td>Regulatory environment is relatively supportive of incumbents, while moderately pursuing competition-enhancing framework and policies.</td>
<td>Located in markets with good long-term economic fundamentals (i.e., large populations and densities, modest unemployment rates, good disposable income and population growth potential).</td>
<td>Some properties are new/recently renovated.</td>
</tr>
<tr>
<td>BB</td>
<td>Regulatory environment has a balance between regulation and competition-enhancing framework and policies.</td>
<td>Many properties in markets where clientele is local.</td>
<td>Medium to high market share.</td>
</tr>
<tr>
<td>B</td>
<td>Gaming industry generates average revenue for the government.</td>
<td>Some locations that provide only adequate access to surrounding markets.</td>
<td>Adequate asset quality, with some renovations completed recently.</td>
</tr>
</tbody>
</table>

Gaming Companies in the Gaming Industry
November 2014
### Gaming – Primary BRR Factors

<table>
<thead>
<tr>
<th>Geographic Diversification</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Significant exposure to different countries, regions and localities, as compared with competitors.</td>
<td>• Some geographic spread, providing some performance risk based on regional conditions.</td>
<td>• Reliance on only a few geographic regions, further enhancing risks.</td>
<td>• Very heavy reliance on one/few geographic region(s).</td>
<td>• Very high levels of competition and limited potential for market development in the core area.</td>
</tr>
<tr>
<td>• Excellent mix of access to developed and developing markets, offering continued growth opportunities.</td>
<td>• Limited exposure to developing markets, potentially limiting future growth potential.</td>
<td>• High risk of market saturation.</td>
<td>• Moderate margins relative to competitors.</td>
<td>• Low margins relative to competitors.</td>
</tr>
<tr>
<td></td>
<td>• Some geographic diversification.</td>
<td>• Relatively moderate to high levels of wins per machine (i.e., above-average utilization).</td>
<td>• Moderate levels of wins per machine (i.e., average utilization).</td>
<td>• Low levels of wins per machine (low utilization).</td>
</tr>
<tr>
<td></td>
<td>• Excellent mix of access to developed and developing markets, offering continued growth opportunities.</td>
<td>• Comparatively moderate return on capital.</td>
<td>• Moderate return on capital.</td>
<td>• Low return on capital.</td>
</tr>
<tr>
<td></td>
<td>• Some geographic diversification.</td>
<td>• Total size of properties offers some economies of scale, offering certain benefits in advertising and promotion and/or investment in newer technologies.</td>
<td>• Average size and economies of scale, limiting advertising and promotional benefits</td>
<td>• Small relative size and no economies of scale.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operational Efficiency</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Very high margins relative to competitors.</td>
<td>• Moderate to high margins relative to competitors.</td>
<td>• Moderate margins relative to competitors.</td>
<td>• Low margins relative to competitors.</td>
<td></td>
</tr>
<tr>
<td>• Relatively high levels of wins per machine (i.e., high utilization).</td>
<td>• Relatively moderate to high levels of wins per machine (i.e., above-average utilization).</td>
<td>• Moderate levels of wins per machine (i.e., average utilization).</td>
<td>• Low levels of wins per machine (low utilization).</td>
<td></td>
</tr>
<tr>
<td>• High levels of return on capital.</td>
<td>• Comparatively moderate return on capital.</td>
<td>• Moderate return on capital.</td>
<td>• Low return on capital.</td>
<td></td>
</tr>
<tr>
<td>• Economies of scale sufficient to allow larger advertising and promotional campaigns, and the investment in and use of newer technologies to improve processes and efficiencies.</td>
<td>• Total size of properties offers some economies of scale, offering certain benefits in advertising and promotion and/or investment in newer technologies.</td>
<td>• Average size and economies of scale, limiting advertising and promotional benefits</td>
<td>• Small relative size and no economies of scale.</td>
<td></td>
</tr>
</tbody>
</table>

The following BRR risk factors are relevant to issuers in all industries (although the relevance of sovereign risk can vary considerably):

**Sovereign Risk**

The issuer rating may, in some cases, be constrained by the credit risk of the sovereign; in other words, the rating of the country in which the issuer operates generally sets a maximum rating for the issuer. If the issuer operates in multiple countries, and a material amount of its business is conducted in a lower-rated country, DBRS may reflect this risk by downwardly adjusting its issuer rating.

**Corporate Governance**

Please refer to [DBRS Criteria: Evaluating Corporate Governance](#) for further information on how DBRS evaluates corporate governance and management.
ADDITIONAL BRR FACTORS

• The additional BRR factors discussed below may be very important for certain issuers, depending upon their activities, but they do not necessarily apply to all issuers in the industry.

Real Estate Ownership

• Ownership of properties can provide greater operating flexibility, in that expansion or contraction of properties does not involve the cash expense of lease termination. On the other hand, the leasing of properties can be extremely advantageous in the case of low-rent, long-term leases, but property closure is more difficult and expensive. DBRS will adjust financial ratios to reflect off-balance sheet lease obligations.

Capital Spending

• The gaming industry can be a capital-intensive business. A company can undertake large capital projects in order to either meet growing demand in a high-growth area or significantly refurbish aging assets to increase/maintain market share. This could potentially lead to cost overruns and weaker financial metrics, at least during the growth phase.
• Key aspects of capital spending analysis include the cash flow adequacy to finance ongoing necessary maintenance requirements and a company’s flexibility in altering the timing of projects. Capital spending analysis provides an understanding of a company’s operating strategies, growth plans and areas under active investment and divestment.
• Gaming operators in certain jurisdictions may receive government assistance for growth and/or maintenance capital spending.

Ownership/Governance

• Aboriginal gaming issuers may pose unique challenges with respect to corporate governance, as these issuers may face pressure to increase distributions to the community rather than investing to upgrade or expand gaming operations. In addition, DBRS's recovery analysis for non-investment grade instruments, where applicable, may need to consider jurisdictional issues that could affect the issuers’ ability to realize on collateral security.
Gaming Financial Risk Rating

PRIMARY FRR METRICS

• The FRR grid below shows the primary FRR metrics used by DBRS to determine the FRR. While these primary FRR metrics are shown in general order of importance, depending upon an issuer’s activities, the ranking can vary by issuer.
• DBRS ratings are primarily based on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS’s opinion on future metrics, a subjective but critical consideration.
• It is not unusual for a company’s metrics to move in and out of the ranges noted in the grid below, particularly for cyclical industries. In the application of this matrix, DBRS looks beyond the point-in-time ratio.
• Financial metrics depend on accounting data whose governing principles vary by jurisdiction and, in some cases, industry. DBRS may adjust financial statements to permit comparisons with issuers using different accounting principles.
• Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios in the FRR grid below.
• Liquidity can be a material risk factor, especially for lower-rated non-investment grade issuers. DBRS will consider available sources of liquidity, including cash on hand, cash flow, access to bank lines, etc., as well as uses of liquidity such as operations, capital expenditures, share buybacks and dividends for every issuer.
• DBRS considers an issuer’s financial policy, including factors such as its targeted financial leverage, its dividend policy and the likelihood of share buybacks or other management actions that may favour equity holders over bondholders.
• While market pricing information (such as market capitalization or credit spreads) may on occasion be of interest to DBRS, particularly where it suggests that an issuer may have difficulty in raising capital, this information does not usually play a material role in DBRS’s more fundamental approach to assessing credit risk.

Gaming - Primary FRR Metrics

<table>
<thead>
<tr>
<th>Primary Metric</th>
<th>A</th>
<th>BBB</th>
<th>BB</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow-to-debt¹</td>
<td>&gt;30%</td>
<td>20% to 30%</td>
<td>10% to 20%</td>
<td>&lt; 10%</td>
</tr>
<tr>
<td>Debt-to-EBITDAR¹</td>
<td>&lt;2.0x</td>
<td>2.0x to 3.5x</td>
<td>3.5x to 5.0x</td>
<td>&gt; 5.0x</td>
</tr>
<tr>
<td>EBITDAR coverage¹</td>
<td>&gt;7.0x</td>
<td>4.0x to 7.0x</td>
<td>2.0x to 4.0x</td>
<td>&lt; 2.0x</td>
</tr>
<tr>
<td>Debt-to-capital¹</td>
<td>&lt;30%</td>
<td>30% to 45%</td>
<td>45% to 60%</td>
<td>&gt; 60%</td>
</tr>
</tbody>
</table>

¹. Adjusted for operating leases per DBRS’s standard criteria.

ADDITIONAL FRR METRICS

• While the primary FRR metrics above will be the most important metrics that DBRS will use in determining the FRR of an issuer, other metrics may be used, depending upon an issuer’s activities, capital structure, pension liabilities and off-balance sheet obligations.
• Profitability, particularly in the medium term, can be an important differentiator of credit risk. DBRS may assess profitability through a variety of metrics, including return on capital.
• While free cash flow (i.e., net of changes in working capital, dividends and capital expenditures, etc.) can be volatile and, on occasion, negative, DBRS may use this and/or other cash flow metrics to assess a company’s ability to generate cash to repay debt.
Blending the BRR and FRR into an Issuer Rating

- The final issuer rating is a blend of the BRR and FRR. In most cases, the BRR will have greater weight than the FRR in determining the issuer rating.
- At the low end of the rating scale, however, particularly in the B range and below, the FRR and liquidity factors play a much larger role, and the BRR would, therefore, typically receive a lower weighting than it would at higher rating levels.

Rating the Specific Instrument and Other Criteria

- For non-investment grade corporate issuers, DBRS assigns a recovery rating and reflects the seniority and the expected recovery of a specific instrument, under an assumed event of default scenario, by notching up or down from the issuer rating in accordance with the principles outlined in the criteria DBRS Recovery Ratings for Non-Investment Grade Corporate Issuers.
- Preferred share and hybrid considerations are discussed under Preferred Share and Hybrid Criteria for Corporate Issuers.
- The issuer rating (which is an indicator of the probability of default of an issuer's debt) is the basis for rating specific instruments of an issuer, where applicable. DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to the general rating information contained in the DBRS rating policy Underlying Principles.
- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy Short-Term and Long-Term Rating Relationships and the criteria Commercial Paper Liquidation Support Criteria for Corporate Non-Bank Issuers.
- The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria Rating Holding Companies and Their Subsidiaries.
- Guarantees and other types of support are discussed in Guarantees and Other Forms of Explicit Support.
- For further information on how DBRS evaluates corporate governance, please refer to DBRS Criteria: Evaluating Corporate Governance.
- Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments – Non Financial Companies for definitions of, and common adjustments to, these ratios.