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High gaming tax, slots at racetracks could cost state between \$525 million and \$675 million in sale of 10th casino license

Report from financial analysts also says reliable stream of state revenues from casino industry would be jeopardized by expansion of gaming to racetracks

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CHICAGO -- Illinois' high gaming taxes and the prospect of slot machines at racetracks could cause the potential price of the tenth casino license to drop between \$525 million and \$675 million, undercutting the state's ability to gain a quick revenue boost from the license sale, say leading financial analysts covering the gaming industry.

And, expansion of gaming to racetracks could turn a proposal to add slots at existing casinos into a "net loser" that could jeopardize the state's long-term ability to collect increased tax revenues from gaming, the analysts say.

The independent analysis by gaming experts at Deutsche Bank Securities looked at the tax and revenue implications of several gaming proposals to identify the best approach to addressing the state's fiscal crisis. The analysis found that restructuring the Illinois wagering tax, the nation's highest with its top rate of 50 percent, was an important first step in helping the state meet both short-term and long-term revenue needs.

"The state's best decision would be to roll the tax back to 35 percent, allow the existing operators to have 2,000 positions, and not move forward with slots at tracks," stated a financial analysis completed by gaming, lodging and leisure analysts Marc Falcone and Eric Hausler. "With a rollback in the tax rate to 35 percent, the license is potentially worth far more than in any other scenario.

"The rollback of the tax rate to a more reasonable level is likely to stimulate the type of long-term capital investment that facilitates a stable long-term economic base for the industry and long-term growth in gaming revenues."

The 10th license's value was approximately \$590 million before Illinois increased its top gaming tax rate to 50 percent last year, the analysts calculated. But, according to the report, with the new 50-percent top tax rate – the highest in the country – and positions capped at 1,200 per casino, the estimated value of the license is now about \$350 million.

The analysts forecasted the value of the license could be increased to a maximum of approximately \$750 million, however, by restructuring tax rates and allowing existing casinos to add 800 new positions to the 1,200 currently authorized.

Conversely, should the Legislature introduce slot machines at racetracks – in effect opening several new casinos mostly concentrated in northern Illinois – the value of the license would plummet to anywhere between \$75 million and \$225 million because of the prospect of diminished casino revenues, the analysts calculated.

"With the prospect of slots at tracks, the implied value of the 10th license plummets [because] the potential earnings power of the property becomes much less [and] the potential risk increases substantially," the report said.

It is expected that \$100 million would come off the top of any proceeds to the state from the sale of the 10th license, to reimburse the original Emerald investors, who now hold the license – pending resolution of a dispute with the Illinois Gaming Board.

Looking to the longer term, the analysis found that adding slot machines at racetracks would only yield marginal tax benefits for the state due to diversion of casino customers to the tracks. Those marketplace economics resulting from expansion of gaming would diminish the incentive for casinos to invest in any major capital improvements.

What's more, any gains in taxes realized through slots at tracks would be predicated upon investment and long-term stability by the casino industry in Illinois, which is at best uncertain in an environment where racinos, high taxes and casinos coexist.

In 2002, casinos generated more than \$650 million in tax revenues. Without slots at tracks, the analysts projected that casinos could generate as much as \$920 million in annual taxes through an increase to 2,000 positions per casino coupled with a 35 percent tax rate.

But with the addition of slots at tracks, the state would receive only \$85 million more in annual taxes than under the casino-only scenarios. This increase in tax revenues would take several years to equal the potential immediate gain of \$525 million to \$675 million more in the value of the 10th license without slots at tracks.

"While the incremental taxes [from slots at tracks] might seem relatively compelling at first glance, there are several potential consequences we would highlight that make the prospect of adding slots at each of the Illinois racetracks a less than optimal solution to the state's budget crisis," the analysis said.

The diversion of casino customers to "racinos" -- especially in the highly concentrated Chicago-area market – combined with the 50 percent top tax rate would make it virtually impossible for casino companies to invest in the additional facilities without dire financial repercussions. The Chicago-area casinos are publicly traded companies that answer to the expectations of shareholders and Wall Street.

The combination of slots at tracks, high taxes and regulatory unpredictability could prove “potentially risky to the stability of the ongoing operations of some [casino] operators in the state [...] Stability and reasonable treatment from government authorities are tantamount to capital allocation decisions, which ultimately create jobs and long-term growth in the economy,” the analysis found.

Deutsche Bank Securities’ gaming, lodging and leisure unit covers both large- and small-cap gaming and lodging companies, as well as a variety of leisure and land-based entertainment companies. Prior to joining Deutsche Bank, both Falcone and Hausler worked at Bear Stearns & Co., Inc., where they covered gaming, lodging and leisure. That platform earned the No. 1 *Institutional Investor* ranking for four consecutive years.