Research Update:

Saracen Development LLC Upgraded To 'B-' From 'CCC' On Casino Opening, Strong Operating Performance; Outlook Positive

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PRIMARY CREDIT ANALYST

Brian Chung
New York
brian.chung
@spglobal.com

SECONDARY CONTACT

Melissa A Long
New York
+ 1 (212) 438 3886
melissa.long
@spglobal.com

Rating Action Overview

- Arkansas-based gaming operator Saracen Development LLC's operating performance through its fiscal third quarter of 2021 (fiscal year ends Sept. 30) ramped up quicker than we expected despite its delayed opening and the fallout from the COVID-19 pandemic. As a result, we no longer believe Saracen faces challenges in meeting its fixed charges, and expect its leverage to improve to the high 4x in fiscal 2021.
- Therefore, we raised our issuer-credit rating on Saracen to 'B-' from 'CCC'. We also raised the issue-level rating on the company's senior secured notes by two notches to 'B-'.
- The positive outlook reflects that we could raise our ratings on Saracen over the next year if it continues to improve its operating performance such that we believe its leverage will remain under 5x, incorporating potential future development spending.

Rating Action Rationale

The upgrade to 'B-' reflects Saracen's faster-than-expected EBITDA and cash flow ramp-up to a level that covers fixed charges despite delays in Saracen Casino Resort's opening and initial operating restrictions. Despite headwinds associated with the COVID-19 pandemic, which considerably delayed the casino's opening to late October 2020 from June 2020, Saracen's operating performance has ramped up quickly since its opening in early fiscal 2021. Saracen reported strong sequential revenue growth in its fiscal second and third quarters, and cash flow generation has ramped up to a level that can cover Saracen's fixed charges. Although we believe some of the positive trends are a result of a more limited number of alternate entertainment and travel options, the effects of multiple federal stimulus packages, the rollout of COVID-19 vaccines across the U.S., the relaxation of restrictions (e.g., mask mandates and revised guidance and capacity limits), and sizable consumer savings and pent-up demand, we believe demand for gaming will likely remain relatively stable for the next several quarters given our economists' forecast for good consumer spending growth. Furthermore, we expect Saracen will also benefit from operating in a limited license jurisdiction and its location advantage given its proximity to the densely populated Little Rock market and from easy access to I-530 and U.S. 65, which, by drive-time, makes Saracen the closest casino to Little Rock.

In addition to sequential revenue growth of more than 40% in its fiscal second and third quarters of 2021, Saracen also reported better-than-expected margin performance with an S&P Global Ratings-adjusted EBITDA margin in the mid-40%. Like other regional gaming operators, we believe Saracen reevaluated its planned post-opening cost structure and marketing strategies during the pandemic and that it will be able to maintain many of its cost efficiencies. As a result, we now expect Saracen's margin to be in the high-30% to low-40% range. This compares to our previous forecast for EBITDA margins to be in the high-20% to low-30% range for its first few years of operations. We expect some margin degradation over the next year as we anticipate that Saracen will increase its marketing and labor spending as the property continues to ramp up and will need to compete for consumers' discretionary income as other travel and entertainment options fully reopen. Notwithstanding this margin degradation, we expect leverage to improve to the high-4x area in fiscal 2021 and to further improve to the mid-3x area in 2022 before potential future investment spending.

Future investment spending and financing plans for Phase 2 are important risk factors. Our updated base-case forecast assumes Saracen could build significant cushion relative to our 5x leverage upgrade threshold by the end of its fiscal 2022 before potential future investment spending. Although Saracen's first phase of development is largely complete, we believe it intends to complete the construction of its hotel and event center in Phase 2. Our base case currently does not assume any material capital expenditures (capex) for the completion of Phase 2 given uncertainties around the size of the project, development timeline, and financing plans. We believe Saracen would likely need to seek some additional financing given the potential cost to build out the hotel and event center. Depending on the company's development timeline and the mix of incremental debt and cash flow Saracen uses to fund Phase 2, it could slow the company's deleveraging path.

We believe Saracen is strategically important to its owner, Downstream Development Authority (DDA). Although DDA's ability to provide financial support is limited, we view the new casino as strategically important to its long-term growth prospects. Saracen diversifies DDA into a new and well populated market surrounding Little Rock with limited current and future competition compared with its property in Oklahoma. The new casino also doubled DDA's consolidated gaming offerings and is generating significant cash flow. We expect Saracen will account for over half of DDA's consolidated revenue and EBITDA once it ramps up. DDA owns 100% of Saracen, consolidates it into its financial statements, is required to maintain majority voting power, and has ancestral ties to the area. DDA demonstrated its willingness and intent to support the development by transferring the gaming license to Saracen and providing start-up capital, development, and management services. As a result, our issuer credit rating on Saracen is capped by our issuer credit rating on DDA.

Outlook

The positive outlook reflects that we could raise our ratings on Saracen over the next year if it continues to improve its operating performance such that we believe leverage will remain under 5x, incorporating potential future development spending.

Upside scenario

We could raise the rating one notch once it is more certain Saracen can sustain debt to EBITDA under 5x and EBITDA coverage of total interest above 2x, incorporating future growth investments and potential additional competition. Our issuer credit rating on Saracen is also currently capped by our issuer credit rating on DDA given its strategic importance to DDA's growth objectives and ownership of Saracen.

Downside scenario

We could revise our outlook to stable on Saracen if:

- We expect leverage to be above 5x; and
- This could occur if there is a drop in demand for gaming because of increased competition from alternate entertainment and travel options, or if Saracen fully finances future development spending with incremental debt.

Company Description

Saracen Development LLC owns and operates the Saracen Casino Resort, a full-service casino in Pine Bluff, Ark. The property is being constructed in phases with phase 1 completed in October 2020. Phase 1 included the construction of the annex (a truck-stop gaming outlet with slot machines), casino, and partial build-out of the hotel tower.

Our Base-Case Scenario

Our base case incorporates the following assumptions:

- U.S. real GDP expands by 6.7% in 2021 and 3.7% in 2022.
- U.S. consumer spending rises by 8.1% in 2021 and 4.1% in 2022, which should support casino spending and visitation.
- Saracen Casino Resort opened in October 2020 in Pine Bluff, Ark. Saracen operates a casino with 2,300 slot machines (including 300 at the annex), 50 table games, a sports book, and food and beverage options.
- Saracen Casino Resort will likely generate between $150 million and $170 million in revenues for fiscal year 2021, lower than our prior expectation largely as a result of the casino opening later than previously expected and operating under capacity restrictions. Revenue increases to $210 million to $230 million in the first full year of operations in fiscal year 2022.
- We forecast EBITDA margins will be in the low-40% area in 2021 based on recent expense trends since the opening of the casino and assuming Saracen gains some permanent operating efficiencies from the lifting of capacity limitations in the casino, bars, and restaurants. Saracen also benefits from a relatively low commercial gaming tax rate in Arkansas. We anticipate there will be some margin degradation in fiscal 2022 as the company increases its promotional activity amid competition from alternate entertainment options and the impact of lower margin amenities compared to gaming, such as restaurants and bars.
- These assumptions result in about $60 million to $70 million of EBITDA in fiscal 2021 and $75

million to $100 million in fiscal 2022.

- While we believe that the fourth Arkansas gaming license will eventually be awarded, there remains significant uncertainty around the timing of the selection of a licensee and construction. As a result, we assume minimal impact to operations from existing competition and no additional developments through fiscal 2022.
- We have not incorporated Saracen's planned hotel completion and additional amenities into our base case forecast given uncertainties around timing and our belief it would likely need to seek additional financing given the expected cost to build. Additionally, Saracen's existing financing agreements limit capex.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA in the high-4x area in fiscal 2021, improving to the mid-3x area in fiscal 2022 before potential future development spending.
- EBITDA interest coverage in the high-1x area in fiscal 2021, improving to low-2x in fiscal 2022.

Liquidity

We believe Saracen has an adequate liquidity position for the next 12 months because we expect liquidity sources to exceed uses by 1.2x or more. We expect sources would exceed uses even if our forecast EBITDA declined 15%. We believe the company's ability to secure financing for the construction of its recently opened Saracen Casino Resort, supports sound relationships with its lenders.

Principal liquidity sources:

- Excess cash on its balance sheet;
- Restricted cash to fund remaining project capex; and
- Our expectation for annual operating cash flow generation of $25 million to $30 million in fiscal 2021 and $40 million to $50 million in fiscal 2022.

Principal liquidity uses:

- Amortization under its equipment loans;
- Modest maintenance capital expenditures of around $8 million; and
- Remaining project capex.

Covenants

Saracen's senior secured notes include four financial maintenance covenants, including: maximum total leverage of 5.5x, minimum fixed-charge coverage of 1.25x, maximum capex and a minimum of $5 million unrestricted cash. Under our base case, we expect Saracen to maintain at least 15% cushion under these covenants through fiscal 2022.

Issue Ratings - Recovery Analysis

Key analytical factors

- Although Saracen Development LLC is ultimately 100% owned by Downstream Development Authority, an instrumentality of the Quapaw Tribe of Oklahoma, we view Saracen as a commercial nongovernmental entity. Saracen is a limited liability company organized under Arkansas law. Because it is not a governmental entity, it does not enjoy sovereign immunity like its ultimate owner does and we believe it would likely be subject to U.S. Bankruptcy Code. Additionally, Saracen is not located on tribal land and therefore is not governed by tribal gaming laws. As a result, we believe liens against Saracen's assets would be enforceable in bankruptcy proceedings.
- We raised our issue-level rating on the company's senior secured notes to 'B-' from 'CCC'. The recovery rating remains '3' and reflects our expectation of meaningful (50%-70%; rounded estimate: 55%) recovery for noteholders in the event of a payment default.

Simulated default assumptions

- Our simulated default scenario assumes a default in 2023, driven by a significant decline in cash flow from prolonged economic weakness, which constrains consumer discretionary spending, greater competitive pressures, and much lower-than-expected demand for casino-style gaming in Arkansas.
- We expect that a new operator would value the property at a lower multiple than it would value a casino-hotel with a longer operating record. As a result, we value Saracen using an EBITDA multiple of 5.5x. This is below our standard 6.5x multiple for leisure operators and reflects Saracen's limited operating record and geographic diversity.

Simplified waterfall

- Emergence EBITDA: $39 million
- EBITDA multiple: 5.5x
- Gross recovery value: $215 million
- Net recovery value after administrative expenses (5%): $204 million
- Obligor/non-obligor valuation split: 100%/0%
- Estimated priority claims (equipment loans): $25 million
- Collateral value available for first-lien debt: $179 million
- Estimated first-lien debt at default: $312 million --Recovery expectations: 50%-70% (rounded estimate: 55%)

Ratings Score Snapshot

Issuer Credit Rating: B-/Positive/--

Business risk: Weak

- Country risk: Very low
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: b-

- Group credit profile: b-
- Entity status within group: Strategically important (No impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate

Issuers, Dec. 7, 2016

- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Leisure And Sports Industry, March 5, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

Ratings List

Upgraded; Outlook Action

	To	From
Saracen Development LLC		
Issuer Credit Rating	B-/Positive/--	CCC/Negative/--

Issue Level Rating Raised; Recovery Estimate Revised

	To	From
Saracen Development LLC		
Senior Secured		
Local Currency	B-	CCC
Recovery Rating	3(55%)	3(60%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.