Industry Top Trends 2017
Hotels, Gaming and Leisure

Overview

- **Ratings Outlook**: Discretionary spending in the global leisure industry will likely improve modestly in 2017—the base-case ratings outlook for the sector remains stable, with more than 80% of ratings outlooks on issuers currently stable.

- **Forecasts**: Credit ratios are likely to improve very modestly in 2017, as modest revenue growth will likely contribute to a slight improvement in margin across the sector. Offsetting leverage improvement will likely involve large, higher-rated, leisure companies using excess cash to reward shareholders, and some issuers will probably opportunistically acquire assets.

- **Assumptions**: We expect operating strength in theme parks, continued growth in the cruise segment, slowing revenue gains in lodging, growth in the Vegas and most U.S.-based gaming markets, and a recovery in Macau gross gaming revenue.

- **Risks**: The key risk facing gaming operators across Asia-Pacific remains the impact of ongoing anti-corruption efforts in China. Geopolitical and terrorist events continue to be a risk factor for cruise operators in the luxury, expedition, river segments, and in the European hotel market. We are also watching the potential negative impact from a strong U.S. dollar and the recent U.S. travel ban on inbound international travel.

- **Industry Trends**: We expect modest merger and acquisition (M&A) activity, through acquisitions of single assets or small portfolios, to remain a key component of many gaming and lodging companies’ strategies, in particular given limited opportunities to grow in gaming and a slowing RevPAR environment in U.S. lodging. Ratings impact will depend on how companies’ capitalize the transactions and how the acquired assets improve business positions. Additionally, real estate separations are likely in 2017, with the expected emergence of Caesars Entertainment Operating Co. Inc. from bankruptcy later this year and its anticipated spin of its real estate. Lodging company La Quinta has also expressed a desire to spin its real estate, which follows Hilton’s successful real estate spin in the first week of 2017.

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Ratings trends and outlook

Global Hotels, Gaming and Leisure

Chart 1 – Ratings distribution

The vast majority of ratings are non-investment grade, reflecting high levels of competition and fragmentation in this discretionary and cyclical sector, combined with high leverage in many cases.

Chart 2 – Ratings distribution by sub sector

The majority of ratings are non-investment grade in all sub sectors. There are multiple investment grade ratings in hotels, gaming and leisure sub sectors, with only one investment grade rated cruise company.

Chart 3 – Ratings outlooks

Discretionary spending in the global leisure industry will likely improve modestly in 2017—the base-case ratings outlook for the sector remains stable, with more than 80% of ratings outlooks on issuers currently stable.

Chart 4 – Ratings outlooks by sub sector

Rating stability is present across all sub sectors.

Chart 5 – Ratings outlook net bias

After swinging modestly negative in 2015, ratings outlook bias stabilized in 2016.

Chart 6 – Ratings net outlook bias by sub sector

Ratings outlooks improved in 2016 in cruise, gaming and leisure sub sectors. Outlooks in the hotels sub sector have remained stable for several years.

Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending December 31, 2016.
Industry forecasts

**Global Hotels, Gaming and Leisure**

**Chart 7 – Revenue growth (local currency)**

In 2016, Macau’s recovery helped gaming and dollar strength hurt hotels revenue amid a slowing RevPAR environment. Moderate revenue growth is forecasted across all sub sectors in 2017.

**Chart 8 – EBITDA margin (adjusted)**

We forecast that margin improvement in 2017 is going to be tough given moderately higher inflation expectations in developed economies.

**Chart 9 – Debt / EBITDA (adjusted)**

The base case forecast for modestly improving leverage in 2017 reflects modest revenue growth, but for many issuers, the forecast does not include opportunistic acquisitions and other unexpected leveraging events, which will almost certainly flatten this downward curve in future periods. The disparity in forecasted leverage in the gaming sub sector compared to the others reflects the tendency of many gaming companies to take on high leverage.

**Chart 10 – FFO / Debt (adjusted)**

As with the debt to EBITDA chart, opportunistic leveraging events will almost certainly cause this upward curve to flatten in future periods.

Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate.
Key assumptions

**Gaming**

1. **The good times keep on rolling…in Vegas**
   
   We expect non-gaming revenue, in particular lodging revenue, to be the catalyst for growth in Las Vegas. We anticipate 2017 will be another year of RevPAR growth, in the low-to-mid single digits, despite a slowing lodging cycle across the U.S. We believe the dynamics are still favorable on the Las Vegas Strip for continued average daily rate growth and high occupancy. The Las Vegas Strip will experience almost no new supply growth over the next two years, which compares favorably to other U.S. lodging markets, unless new gaming projects like Genting’s Resorts World Las Vegas or Alon are completed. The timeline and financing for these projects remain uncertain, and we believe it’s unlikely they could open before 2019. Coupled with strong visitation to the market and continued growth in convention visitation, operators should be able to increase rates. On the gaming revenue side, we are forecasting low-single digit growth. However, we expect baccarat revenue, which represents about 20% of total gaming revenue, will remain particularly volatile and could continue declining compared to prior years.

2. **Macau finally recovers**
   
   We expect the opening and ramp up of mass-market-focused new casinos, addition of non-gaming entertainment attractions and hotel rooms, and better transportation connecting Macau with mainland China will drive the rebound in gaming revenue in Macau. We forecast gross gaming revenue in Macau to resume positive growth of 0%-10% in 2017, after a decline by about 3% in 2016. We believe the rebound will also drive a continuous structural shift from the “VIP” (or credit-fueled high rollers) to the mass market gaming segment. We forecast the mass-market segment to grow 5%-10% in 2017, while VIP gaming revenue could swing from a decline of up to 5% to positive growth of 5% during the period given it is more sensitive to changes of the Chinese government’s regulations on the gaming industry. EBITDA margin is also likely to improve because of the continuous revenue shift toward the more profitable mass market segment from VIP, as well as better operating leverage following the recovery in revenues.

3. **Slowing U.S. regional gaming revenue could pressure margins**
   
   We expect gaming revenue growth in U.S. regional markets to be largely correlated to consumer spending growth given maturity of most markets, except where the introduction of new competition hurts an adjacent market. We expect that anemic top line growth will cause casino operators to exercise cost discipline in order to sustain EBITDA, as inflation pressures wages and health benefits. The two largest expenses that gaming companies can typically exert some control over are marketing costs and labor costs. We expect gaming companies to keep refining their use of data and analytics to assess the impact of promotions and incentives on different consumers, as well as revenue and profitability, and adjust spending throughout the year as needed. We believe operators will sacrifice top line revenue if that revenue is not profitable enough. Companies can sustain marketing discipline as long as the economic environment is supportive of discretionary spending and competitors also remain disciplined. Additionally, as inflation drives wages and health care costs higher, we expect casinos to continue to utilize part-time schedules and to focus on efficiencies in scheduling employee hours, including using software tools that can analyze customer traffic patterns and ensure staffing levels are appropriate for the expected number and demographics of customers.
## Hotels

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<tr>
<td>1</td>
<td>U.S. revenue per available room (RevPAR) grows 1% to 3%</td>
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<td>U.S. RevPAR slowed significantly in 2016, to around 3%. Occupancy growth showed signs of life in the month of November 2016 reflecting pent-up demand for travel following the election, but reverted back to zero growth in December 2016. Our bet is that occupancy trends are flat in 2017 as demand grows around 2%, in line with our economists' current expectation for GDP growth, offset by accelerating supply growth around 2% across the industry. Average daily rate should grow between 1% and 3%, as still-record high occupancy rates enable lodging operators to sustain pricing power. Policy uncertainty, the travel ban fallout, and a continued strong U.S. dollar are key risk factors to this base case forecast (see Key Risks and Opportunities for the Lodging sector).</td>
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<td>Wage and cost inflation pressures hotel margin given slowing RevPAR growth</td>
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<td>In the last U.S. jobs report of the year, average hourly earnings rose at the highest pace since the recovery began in mid-2009. Wages are likely to rise further in 2017 as the supply of labor becomes scarcer, and the lodging sector will not be immune to the resulting increase in costs. In addition, the general level of inflation will likely cause food and beverage costs to rise. As a result of this and slow anticipated 2017 RevPAR growth, hotel margins could deteriorate absent offsetting efficiency moves on the part of operators. If hotel profitability suffers, growth in incentive fees would flatten or possibly decline for some hotel managers.</td>
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<td>European RevPAR grows in the low-single digits</td>
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<td>European RevPAR also slowed significantly to less than 2% in 2016 (in euros), especially in western Europe due to terrorism’s lingering negative impact on visitation to key travel markets, particularly Paris and Brussels. Given the current trend and our economists’ forecast for a slowdown in 2017 GDP growth to 1% in the U.K. and to 1.4% in the eurozone, partly offset by low new supply, and incorporating the potential for continued political volatility in Italy and Turkey, European RevPAR as a whole could grow only modestly in 2017, in the low-single digits. This could be so even if key western Europe markets recover and no additional tragic terrorism events occur in 2017.</td>
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**Cruise**

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| **1** | **Net revenue yields grow**  
Constant currency net yields should improve in the low-single digit percent area through 2017 reflecting continued good anticipated consumer demand for cruises and well received new ship builds that command pricing premiums. Net yield growth will also be supported by moderate industry capacity growth of around 6% (according to data provided by Cruise Line International Association, [CLIA] and company information), and a favorable economic environment that should drive pricing discipline across large cruise operators. For the U.S.-based cruise operators, the strong dollar may result in continued pressure on current dollar yields, but lower expenditures in dollar terms for operating costs and ship deliveries provides some offset. |
| **2** | **Capacity expands**  
We estimate 2017 capacity to grow around 6% based on data provided by CLIA and company filings. We believe this level of capacity growth does not represent over-supply, since we believe a favorable economic environment and growing markets such as China, where operators are redeploying existing ships and introducing new builds, will support demand. We expect operators to continue to invest in the Chinese market. In 2017, Norwegian Cruise Lines (NCL) will introduce the Norwegian Joy, and Carnival Corp. will introduce the Majestic Princess, both specifically built and designed for Chinese customers. We expect other operators will either increase capacity in China or continue marketing itineraries specifically for Chinese outbound tourists. Capacity in the Mediterranean should decrease somewhat in 2017, as operators continue to modify itineraries following geopolitical and terrorist events last year that impacted demand in the region. |
| **3** | **Rising fuel costs could slow margin improvement**  
We believe cruise operators’ EBITDA margins may be pressured in 2017 given our forecast for fuel prices to increase, and the impact of the continued strengthening of the U.S. dollar. Nevertheless, we expect growth in net yields and operators’ fuel hedging strategies to dampen these negative impacts. Although we are forecasting oil prices will increase about 7% in 2017, we believe operators’ hedging strategies will mitigate some of this negative impact to EBITDA margin. NCL has hedged on average 79% of its total projected metric tons of fuel consumption for 2017, which we expect will mitigate some of the negative impact of rising fuel costs. We expect Royal Caribbean Cruises Ltd’s fuel costs will remain relatively flat in 2017 since we expect any increases in fuel costs for the portion of its fuel consumption that is not hedged (40%) will be offset year over year declines in fuel costs for the hedged portion (60%). Carnival is more likely to be negatively affected by increasing fuel costs because it does not hedge fuel costs, but rather relies on hedging instruments such as zero cost collars. |
Key risks and opportunities

Gaming

1. Regulatory risks may weigh on gaming markets across Asia-Pacific

The key risk facing gaming operators across Asia-Pacific remains the impact of ongoing anti-corruption efforts in China. The Chinese government has also strengthened its policies and control to curb capital outflows from China since December 2016. Although we have not seen a material impact from the recent regulation tightening on the gross gaming revenue in the region, it could weaken the growth prospect of both VIP gaming segment and the fast-growing premium mass segment. Any further unfavorable regulatory change by the Chinese government could swing the growth of the VIP segment across the region given the majority of the VIP customers are from China, while mass market should be relatively stable, in our view.

2. Could gaming in Japan be the next big thing? Risks will precede the rewards

Japan recently passed a law that could open the door for integrated casino resorts in future periods, paving the way to becoming one of the largest gaming markets in the world. We expect the path to opening integrated casino resorts, however, is likely to be a long one, and we don’t believe a resort will open before 2022, at the earliest. This is because additional legislation will be required in future periods to determine the framework for casino resorts, including tax rates, the number of licenses, location of licenses, size of required investment, and any entrance restrictions. Once the legislation is passed, we expect there will likely be a competitive process for securing a license to develop a casino, and construction of these types of resorts typically takes several years. We expect many rated gaming operators, including Las Vegas Sands Corp., Genting, MGM Resorts International, Wynn Resorts Ltd., Melco Crown, and Caesars Entertainment Corp. will pursue opportunities to build integrated casino resorts in Japan. We expect operators will consider the size of any potential investments in the context of the ultimate legislative framework, which could weigh on the return potential of a project, particularly given high corporate tax rates in Japan and a high cost of land in many areas. Given the need for additional legislation and a likely competitive request for proposals, we believe that any meaningful investment by any of these operators is likely several years away. That said, given the size of possible investments that some operators have outlined in the past, we expect in future periods, the winners of these licenses would incur higher debt and weaker credit measures than we are currently forecasting.

3. Will consolidation continue?

We expect M&A activity, through gaming operators’ acquisitions of single assets or small portfolios, to remain a key component of many companies’ strategies, because there are more limited opportunities to grow organically. This is because gaming in the U.S. is highly competitive and largely mature, which makes it difficult to achieve revenue growth in excess of consumer spending growth. Also, we expect few, if any, new gaming market opportunities over the near term in the U.S. As a result, operators are looking to M&A transactions as a way to drive faster growth and improve economies of scale. We also expect gaming real estate investment trusts, like Gaming & Leisure Properties and MGM Growth Properties, are actively looking to acquire as a way to grow. While there is still relatively good availability of capital, the rising cost of financing could slow the pace of large leveraging acquisitions. The extent to which these transactions impact ratings will depend on how companies’ capitalize acquisitions and how the acquired assets improve business positions. Additionally, real estate separations remain present in 2017, with the expected emergence of Caesars Entertainment Operating Co. Inc. (CEOC) from bankruptcy later this year. We expect CEOC to spin its regional gaming and Caesars Palace Las Vegas real estate into a real estate investment trust that will be controlled by lenders. Over time, we believe it’s possible that lenders may look to divest this real estate if it’s not a core component of their longer term strategy.
Hotels

1. Assumed policy changes are fluid and meet congressional reality
   
   We will probably see fluid policy positions from the new administration in 2017. In addition, whatever policy changes are pursued will need to be crafted into bills and voted on in Congress. Rarely does the initial policy idea equal the final legislation. Still, lodging is highly sensitive to economic growth and the health of consumer spending, and any meaningful changes in trade or fiscal stimulus policies such as taxation and infrastructure spending, that either increase or decrease forecasted economic growth, would impact lodging revenue trends in the same direction.

2. Strong dollar, travel ban = negative impact on inbound U.S. travel
   
   Continued strength in the U.S. dollar compared to the euro and the pound could cause inbound European travelers to determine that travel to the U.S. is too expensive. Also, if the Trump Administration’s review of visa rules and the pursuit of a travel ban are prolonged, or such measures result in a sustained negative global reaction, the American brand as an attractive travel destination could be harmed. Although annual inbound international travel to major U.S. gateway cities is somewhere around the single digits on average as a percentage of total bookings, depending upon the hotel group, we believe international travel to the U.S. can spike to a higher level during peak summer months. These risk factors could depress RevPAR growth in the U.S. through lower occupancy at gateway city hotels, or by potentially causing hotel operators to reduce rates (or increase them at a slower rate).

3. European travel
   
   We expect security risks to continue to meaningfully affect the European travel sector in 2017, following a turbulent 2016 blighted by a series of terrorist attacks. We think the impact on issuers will vary depending on their geographic diversification, and where they lie in the travel value chain. Hoteliers present in France, Belgium, Turkey, or North Africa are likely to continue recording negative RevPAR and subdued earnings, but those focused in Spain, Italy, and Greece are likely to benefit as European travel is redirected to these regions. Europe’s tour operators actually showed resilience in 2016, demonstrating their ability to redirect capacity to higher-demand markets in Europe or long-haul destinations at short notice, and absorbing the cost while maintaining earnings at least at the levels of the previous year. As long as certain key European holiday destinations remain open, we see no reason why 2017 could not at least match 2016’s relatively subdued performance developments--although we will monitor event risks closely. As for online travel agencies, we have yet to observe a notable impact from security risks, since these issuers generate revenues from travel in any direction.
### Cruise

#### Event risk
Geopolitical and terrorist events continue to be a risk factor for industry demand in 2017, particularly for cruise operators in the luxury, expedition, and river segments. These operators generally cater to retirees, who tend to have more flexibility with respect to vacation schedules and therefore can more easily postpone or cancel vacations if they have safety concerns. This drives exposure to both lower occupancy and net revenue yield pressure following events. In 2016, the impact of geopolitical and terrorist events was more pronounced for Mediterranean itineraries. Operators have taken steps to modify itineraries or move capacity to other regions. We believe this lower supply in the Mediterranean in 2017 will support improved occupancy and pricing for those itineraries by the end of 2017.

#### Capital expenditures
High levels of capital expenditures continue to be a risk factor for cruise operators since ship building commitments must be secured as many as five years in advance. These advanced commitments expose operators to meaningful swings in credit measures because if ship deliveries occur during periods of weak operating performance, operating cash flow may be insufficient to fund ship costs and operators will typically increase their borrowing to fund any remaining costs. We believe, however, that operators will take a measured approach with respect to new builds over the next few years since shipyard capacity is limited—there are only about four major shipyards globally. Given operators’ new build programs, and data from CLIA, which estimates there are 97 ships on order (including both ocean and river ships) between 2017 and 2026, we expect the major shipyards will be at full operating capacity for the next few years. We believe this, along with the long lead times to build ships, will preclude operators from unexpectedly, or meaningfully increasing their new build related capital expenditure levels over the near term.

#### Cruise market in China continues developing
China remains a key growth opportunity for cruise operators, and many are repositioning existing ships into this market and introducing new ships designed specifically to take advantage of its growth potential. While we expect industry capacity in China to grow 20% in 2017, cruise capacity in China still represents a relatively small, albeit increasing, percentage of cruise operators’ total capacity. As cruise capacity in China continues increasing across operators, we expect yields in China to decline, although we still expect them to be good relative to fleet averages. We expect the cruise market in China should benefit from a growing middle class with rising income, as well as improving infrastructure and transportation that improve connectivity within the country and make it easier for passengers further inland to travel to port cities in order to cruise. Estimates from CLSA suggest China outbound tourism and Chinese tourism expenditures will grow at a compound annual growth rate of 10% through 2020. Given this growth trajectory, we believe the industry will absorb the new capacity set to launch in Asian cruise markets.
Industry developments

U.K. gaming may see combinations in 2017

A number of completed and proposed M&A transactions in 2016 highlighted the U.K.’s betting and gaming industry’s desire for consolidation within the domestic market, and expansion into overseas markets, driven in part by the ever-rising burden of regulatory costs. Remote gaming has become a key growth driver for the industry, and we expect operators with strong brand and product propositions to continue achieving double digit revenue increases in the digital segment in 2017. We expect heightened levels of M&A activity to continue, given the persistence of driving forces which have emerged in the recent past, including:

- Volatility of profitability and margin pressure arising from regulation, which may be mitigated to an extent by a more balanced mix of revenues, both between betting and gaming, and between land-based and remote channels.
- Cross-border transactions as a means of acquiring share in lower-penetration markets with potential for rapid growth as the domestic online market moves towards maturity, and the land-based market exhibits gradual decline.
- Acquisition of technological capabilities and established brands in order to differentiate the customer proposition and strengthen competitive positions, which we view as critical success factors for digital operators.

As a result, we see the potential for further debt issuance from both seasoned and first-time issuers to finance M&A activity leading to increased industry leverage. We do not anticipate further material consolidation in the U.K. land-based segment due to restrictions imposed by competition authorities. We anticipate increasing levels of industry capex, which may constrain free operating cash flow, both as a result of post-transaction integration and the needs of non-acquisitive peers to invest in their technological capabilities. In addition, we see the potential for increased shareholder returns as a risk to discretionary cash flows.

M&A could weigh on credit quality of terrestrial gaming companies in Canada

In 2017, we expect Canadian casino operators to remain opportunistic in pursuing terrestrial gaming bundles in the attractive Ontario market. We believe bidding for these strategically important assets will prove to be competitive, and that the acquisitions will likely increase debt leverage. While asset quality and diversity of revenue could improve somewhat, and most assets should provide for favorable economics, it might not be sufficient to support credit quality of some operators. Furthermore, through 2017, West Coast Casino operators will continue to be challenged by new conditions placed by the B.C. regulator on VIP players in late-2015 (specifically, the requirement to demonstrate source of funds) against the backdrop of still-tough and increasingly uncertain economic environment for players from China---who represent an important source of cash flow.

Cannibalization risk remains in Macau’s gaming industry

Cannibalization could occur between new and existing casinos in Macau, especially during the period when several new casinos open together and demand is weaker than casino operators’ expectation. We believe it will take the market more time to absorb the recently added new capacity, and that existing properties could face revenue cannibalization in 2017. Additionally, new casinos may not receive large gaming table allocations, which could lengthen their payback periods. Nevertheless, we believe the worst is behind the industry. Four of six Macau gaming concessionaires have already commenced operations for their new casinos in Macau’s Cotai district over the past 12-24 months, with only one new casino set to open in 2017 and another one in 2018.

U.S. timeshare goes its own way, and sheds some capital intensity

We believe transaction activity will be slower in 2017 now that all major hotel companies have spun or sold their timeshare operations. In 2016, Diamond bought Intrawest’s timeshare unit, Interval bought Vistana from Starwood, Apollo bought Diamond, and Hilton Worldwide spun off HGV. We also believe continued good sales execution should enable many rated operators in the industry to maintain
revenue growth slightly higher than overall consumer spending. We have seen large operators like Wyndham and Marriott Vacations shift focus to acquiring new customers rather than selling to existing owners, and we expect that trend to continue. The challenge will be whether they can manage marketing and other costs and preserve margins while adding new owners to their systems. Overall, we expect timeshare ratings to be stable in 2017. Even though we believe modest business improvement is possible for some as the industry continues to experiment with capital-light inventory sourcing models, it probably will not be enough to offset the key risk factor of high volatility experienced by this high priced, discretionary, leisure product.

Related research
Cash, debt and returns

Global Hotels, Gaming and Leisure

Chart 11 – Cash and equivalents / Total assets

Chart 12 – Total debt / Total assets

Chart 13 – Fixed versus variable rate exposure

Chart 14 – Long term debt term structure

Chart 15 – Cash flow and primary uses

Chart 16 – Return on capital employed

Source: S&P Global Market Intelligence, S&P Global Ratings calculations