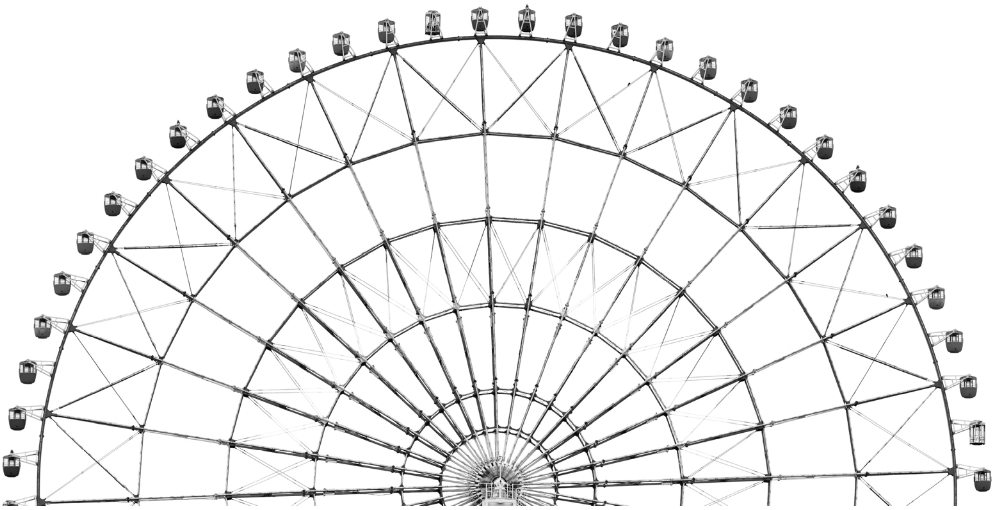
S&P Global Ratings

Industry Top Trends 2019

Hotels, Gaming, and Leisure

November 13, 2018



Key Takeaways

- **Ratings Outlook:** Discretionary spending in the global leisure industry will likely improve modestly in 2019—the base-case ratings outlook for the sector remains stable for now. However, the recent trend in ratings activity has been negative mostly because of leveraging mergers and acquisitions (M&A) and other transactions and by company-specific operating underperformance related to a sustained deterioration in competitive positions and margin.
- **Forecasts:** We expect slowing net revenue yields in the global cruise industry, moderate revenue growth in Las Vegas and Macau, modest revenue per available room (RevPAR) growth in U.S. lodging, surprising resilience in European RevPAR, and good growth in the theme park sector.
- **Assumptions:** Anemic top-line growth will cause casino operators to exercise cost discipline to sustain EBITDA, as inflation pressures wages and health benefits. Casino companies will likely remain disciplined on promotional spending. However, it would become challenging to remain disciplined about marketing spending if consumer spending declines. Moderate RevPAR growth will not offset increasing labor and other cost inflation in lodging, which will pressure hotel profitability. Hotel managers and franchisers, as they do not bear hotel costs, will fare better. Because cruise companies have already achieved their leverage targets, another year of moderate net revenue yield and EBITDA growth will push them to repurchase shares at a faster clip.
- **Risks:** Our article addresses the expanding U.S. sports betting industry, increased regulation in European gaming, M&A in lodging, increasing shareholder returns in the cruise segment, and the impact of an unexpected sharp downturn in the global economy in 2019 in the gaming, lodging, and cruise sectors.
- **Industry Trends:** We address a variety of industry trends, including the impact of Brexit on European travel, the Macau concession rebidding process, the emerging gaming development opportunity in Japan, the upcoming recreational vehicle sales (RV) slowdown, the impact of potential toy tariffs, big Canadian casino investment, regional theme park seasonality, and the Latin American travel and hotel outlook.

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Ratings trends and outlook

Global Hotels, Gaming, and Leisure

Chart 1

Ratings distribution by region

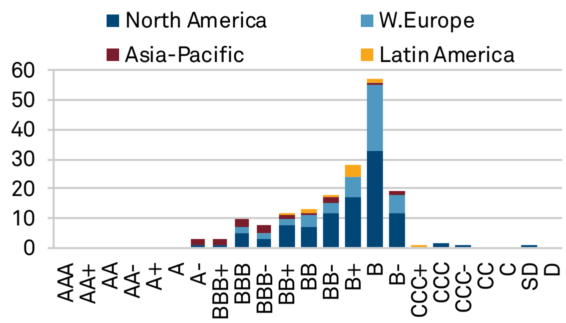


Chart 2

Ratings distribution by subsector

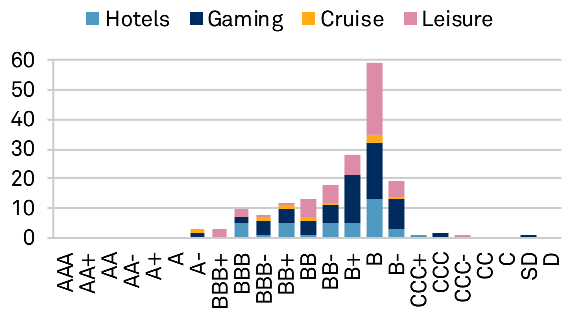


Chart 3

Ratings outlooks

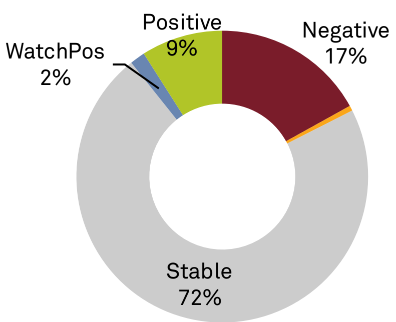


Chart 4

Ratings outlooks by subsector

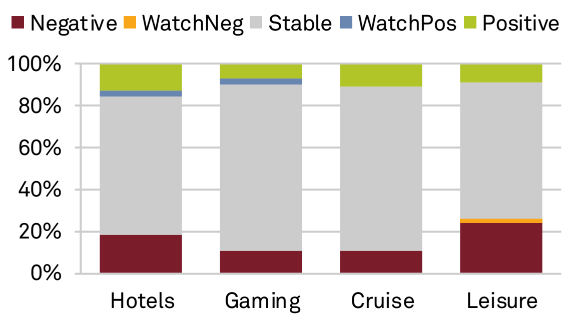


Chart 5

Ratings outlook net bias

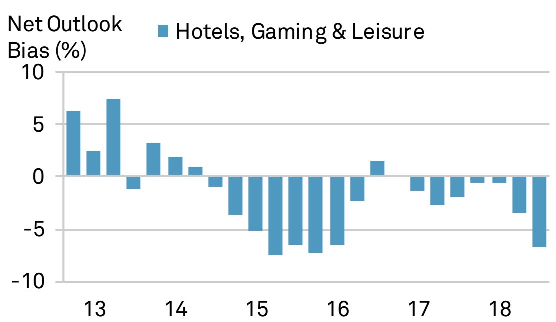
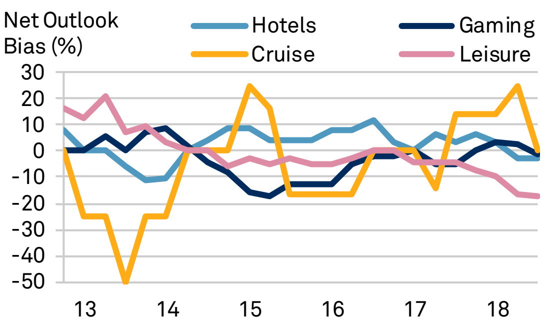


Chart 6

Ratings net outlook bias by subsector



Source: S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending September 30, 2018

The recent trend in ratings activity has been negative, mostly because of leveraging M&A and other transactions and company-specific operating underperformance related to a sustained deterioration in competitive position and margin.

Industry forecasts

Global Hotels, Gaming, and Leisure

Chart 7

Revenue growth (local currency)

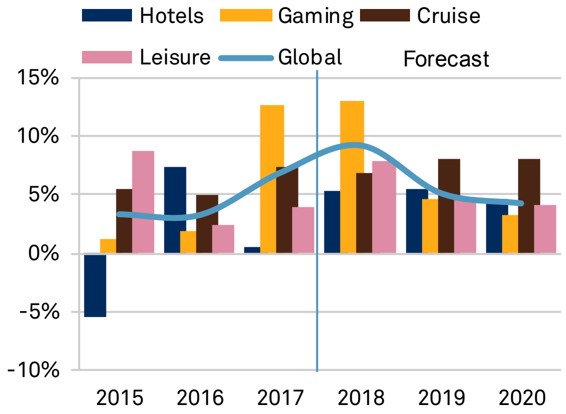
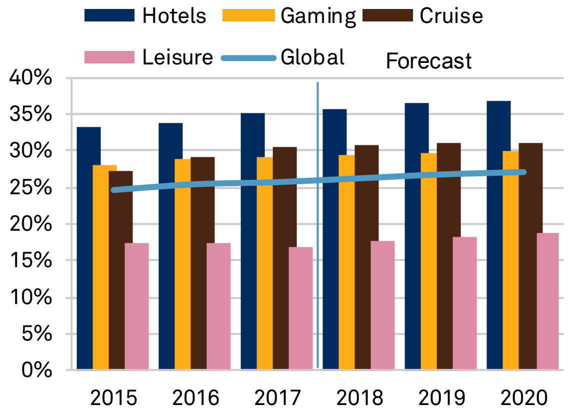


Chart 8

EBITDA margin (adjusted)



The double-digit gaming revenue recovery in 2017 and 2018 in Macau is weighted heavily in the gaming sector because of the scale of operators in the market. Cruise revenue growth through 2020 reflects mid-single-digit industry capacity growth and higher anticipated net revenue yields.

Chart 9

Debt / EBITDA (median, adjusted)

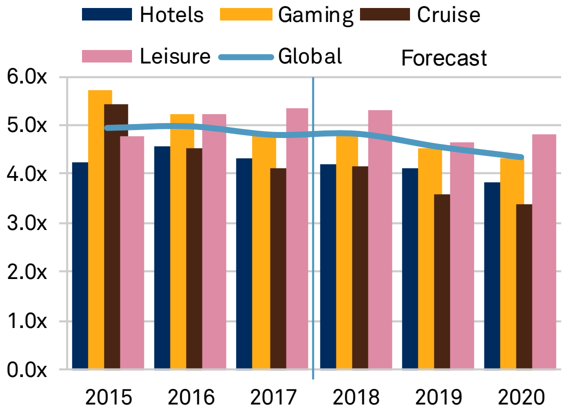
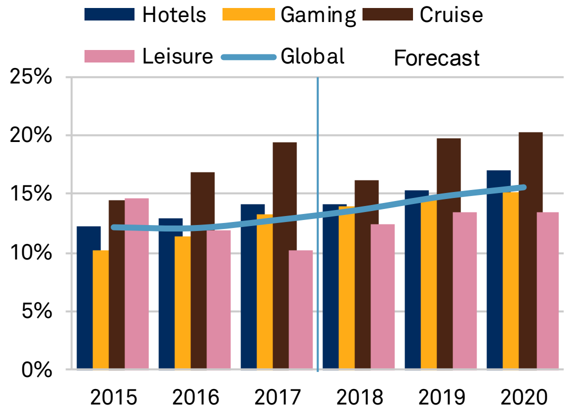


Chart 10

FFO / Debt (median, adjusted)



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. FFO--Funds from operations.

Key assumptions

Gaming

1. Las Vegas forecast

We expect gaming revenue and RevPAR in Las Vegas to grow 1%-3% in 2019, in line with our economists' forecast for consumer spending growth and our forecast for RevPAR growth across most U.S. lodging markets. Although Las Vegas experienced some weakness in RevPAR through the third quarter, we believe this is largely the result of the lingering aftermath from the mass shooting, the absence of a large citywide trade show (it's an off year for CONEXPO-CON/AGG), and a very unfavorable entertainment and meeting calendar in the third quarter of this year. We expect RevPAR growth to turn positive again in the fourth quarter of 2018. Las Vegas 2019 RevPAR growth will largely result from higher average daily rates (ADRs), as opposed to meaningful changes in occupancy given already high occupancy levels over 90% on the Las Vegas Strip. Las Vegas offers good value and a broad array of room types and amenities for conventions and trade shows, supporting growth in convention visitation. Additionally, Las Vegas's expanding entertainment options make it a compelling destination for a broad array of leisure travelers, not just gaming customers. While there are several large casino resorts under construction toward the northern end of the Las Vegas Strip, we believe these properties are unlikely to open before the end of 2020. Thus, given expected continued strong visitation and convention business and no material supply changes, we believe the market can absorb moderate increases in room rates. We believe resort fees, which have been implemented across most resorts at this point and may have supported faster RevPAR growth in prior years, are unlikely to be a material driver of RevPAR growth going forward.

2. Mass market is key growth driver for Macau

While the VIP gaming segment was largely responsible for the surge in gaming revenue growth in 2017 and the first half of 2018, we expect mass market gaming revenue to be the steady growth driver for the second half of 2018 through 2019. Though gross gaming revenue (GGR) growth in 2019 is likely to decelerate as a result, we believe this trend is still largely positive for casino operators. This is because the mass segment is far more profitable for casino operators with profit margins that are 3x-4x higher than the VIP segment. We forecast Macau's 2019 GGR growth to slow to about 4%-8% from 12%-14% in 2018 (above our previous 2018 forecast of 6%-12%). This incorporates mass gaming revenue growth of about 6%-10% in 2019, supported by improving infrastructure from China to Macau—such as the recently opened Hong Kong-Zhuhai-Macau Bridge—and additional hotel room capacity with the opening of MGM Cotai and Morpheus in 2018 and potentially the Grand Lisboa Palace in the second half of 2019. We expect VIP gaming revenue growth to decelerate to about 2%-6% in 2019, partly due to tightening liquidity in China and other potential risks such as knock-on effects from the U.S.-China trade war. Other risks to Macau's GGR growth rate include the new restrictions that will ban smoking at tables, limiting it to approved lounges, that will be enforced starting January 2019 and regulatory risks such as restrictions on UnionPay, corruption crackdown, or visas.

3. New market opportunities (or lack thereof) and stringent regulation drive consolidation and possibly volatility in credit measures

We expect consolidation in gaming to continue, as observed in the past couple of years with several large mergers in the industry. The opening of the U.S. market to sports betting will be one of the drivers further supporting this trend in 2019. We believe mergers in the U.S. could be in the form of joint ventures (JVs) or primarily debt-financed acquisitions that could increase leverage. Nevertheless, many companies have used good cash flow growth to build in some cushion in leverage to provide flexibility for opportunistic acquisitions. We also believe the U.S. gaming REITs will actively pursue acquisitions, using a mix of debt and equity financing, to expand their asset bases and improve geographic and tenant diversity. The extent to which M&A affects ratings will likely depend on their ability to issue sufficient equity to remain within their financial policy goals.

In addition, we expect relatively slow growth and limited new development opportunities (outside of sports betting) for U.S. and European gaming operators to spur consolidation. In most U.S. and European gaming markets, we generally expect gaming revenue to grow by low-single digits in 2019, absent changes in competition or regulation that hurt revenue. The online segment, particularly in Europe, continues to be a strong source of growth, and we expect operators with strong brand and product propositions to continue achieving double-digit revenue increases in this segment in 2019. Retail-based betting will continue to show a relatively stable trend, with a small decline in some specific markets that experienced high regulation, like the U.K., Italy, and Germany. Additional regulation and taxation could further weigh on gaming companies, pressuring earnings and overall profitability in 2019.

Hotels

1. U.S. RevPAR grows modestly 1%-3%

We forecast U.S. RevPAR will grow a modest 1%-3% in 2019, driven entirely by ADR growth. Our macroeconomists currently believe GDP growth remains above trend, but will moderate to 2.3% in 2019 from 2.9% in 2018, primarily because the stimulative effects of tax reform wear off a little next year and because we factor in escalating tariff risks in 2019. Still, anticipated strength in the labor market and still-bullish consumer confidence should cause hotel demand to grow at least around 2% in 2019, which would absorb anticipated 2% supply growth next year, leaving occupancy rates flat but at record high levels. As a result, we forecast that lodging operators will continue to have the ability to raise ADR, which will grow around 2% in 2019, ultimately leading to 1%-3% RevPAR growth. This level of RevPAR growth is probably too modest to offset wage and other cost inflation, and hotel EBITDA margin will likely suffer in 2019 as a result..

2. Wage and other cost inflation will pressure hotel margin

We believe worker demands for wage and benefits increases are accelerating in the hotel industry amid a still strong economy and 2.9% wage growth in the U.S. in the second quarter of 2018 -- the fastest rate in 10 years, according to our economists. Job openings were at an all-time high in July 2018 and our economists forecast a sustained pick-up in wage growth in the coming quarters. In addition, strikes at Marriott, Hilton, Hyatt, and other branded hotels in Chicago, San Francisco, Boston, and Hawaii have made headlines as unionized hotels workers bargain for better pay and benefits. Successful campaigns to raise minimum wages up to $15 per hour in some key hotel markets could also pressure costs as hotels are forced to match higher paying service jobs in other industries. Given our forecast is for modest RevPAR growth between 1%-3%, even at the high end of this range it is unlikely that hotels can improve EBITDA margin in 2019 because labor represents the largest cost line item at greater than 40% of total costs, according to a number of studies. Other cost inflation, including food and beverage, taxes, and utilities, will also likely pressure margin in 2019 absent incremental efficiencies. The impact on hotel managers and franchisers will be less than on hotel owners, which bear the burden of hotel costs.

3. European RevPAR grows in the low-single digits

Given the current trend of RevPar growth of 5.2% year to date as of August 2018 and our economists' forecast for a slowdown in 2019 GDP growth to 1.3% in the U.K. and to around 1.7% in the Eurozone, we expect RevPar growth of 4%-5% in 2018 and low-single digits in 2019. We expect RevPar growth to slow in 2019 in the U.K. to 0%-1%, mostly due to uncertainties around Brexit, a high pipeline of new room openings, and softer economic conditions, offset somewhat by a weakening pound. We don't expect significant movement in occupancy rates in the U.K. overall. We do expect a modest occupancy decline for London hotels due to an increase in supply over the past several years. ADR growth should offset the London occupancy decline. European RevPAR (excluding the U.K.) could grow 3%-5% in 2019, absent any terrorism events and incorporating the potential for continued political volatility in Italy and Turkey. The best performers are expected to be France, with strong 2019 RevPAR growth in the high-single digits anticipated in Paris, and Benelux. 2019 RevPAR in Spain is expected to be flat to slightly negative due to the political situation in Catalonia, and a prolonged correction following an extremely strong 2017, when Spain benefitted from high demand redirected from markets affected by terrorist attacks.

Cruise

1. Net revenue yields grow, albeit at a slower pace

We expect constant currency net yields to improve at a slower pace than in 2018, given higher capacity growth next year and our economists' forecast for decelerating GDP and consumer spending growth. We forecast net yields to increase in the low-single digits (2%-3%) in 2019. Despite increased capacity growth in 2019 compared to 2018, we believe this level of capacity growth can be absorbed since we believe continued economic growth and consumers' tendency to vacation each year and their increasing desire for experiences will support demand. Demographic trends are also favorable and support increasing leisure spending over the next few years, and cruises remain a relatively small portion of overall leisure spending. We also expect that as long as the economic environment remains supportive, cruise operators will maintain pricing discipline, supporting net yield growth.

2. Capacity continues to expand

We estimate 2019 capacity will grow around 7% based on data provided by Cruise Line International Assn. (CLIA) and company filings. We expect a majority of this capacity growth to be in the Caribbean, Europe, and Alaska, driven by strong demand for these itineraries, and as operators look to deploy capacity to higher-yielding destinations and itineraries. After a year of declining cruise capacity in the Chinese market, we don't expect any material changes in Chinese cruise capacity in 2019 despite the introduction of two new purpose built ships for the Chinese market in 2019 by Carnival's Costa brand and Royal Caribbean, as these ships will sail in the region for only about half the year and Norwegian Joy is leaving the market. Because ships are mobile assets and operators have a limited number of them, operators will continue to focus capacity on markets that generate the greatest returns. If ships deployed in China don't earn the same premium that similar ships sailing in more established markets earn, operators will reposition that capacity to higher-yielding markets as long as demand there remains robust.

We also expect increased capacity growth in the luxury and expedition segments over the next few years. Strong demand for experiential travel and the high yields these ships earn because of their unique experiences are leading operators in these segments to add more capacity, and have also drawn the attention of other operators, including Viking, Royal, and Carnival, to invest in this segment.

3. Rising fuel costs could pressure margins

We believe rising fuel costs through 2019 may pressure cruise operators' EBITDA margins and slow EBITDA growth, since fuel costs represent a sizable portion of a cruise operator's overall expense base. Fuel prices have risen significantly in 2018, and we believe it is likely that they will continue increasing faster than inflation (and faster than our forecast yield growth) next year. Nevertheless, we expect growth in net yields and operators' fuel hedging strategies to somewhat dampen these negative impacts. Additionally, newer ships are more fuel efficient, which will lead fuel consumption to rise more slowly than capacity growth. NCL has hedged on average 48% of its total projected fuel consumption for 2019, which we expect will mitigate some of the negative impact of rising fuel costs. We expect Royal Caribbean's fuel costs to remain relatively flat in 2019 since we expect that any increases in fuel costs for the portion of its fuel consumption that is not hedged (49%) will be offset by year-over-year declines in fuel costs for the hedged portion (51%). We believe Carnival is most exposed over the near term to increasing fuel costs because it does not hedge fuel costs.

Key risks and opportunities

Gaming

1. The nascent U.S. sports betting industry

Following the U.S. Supreme Court's May 2018 repeal of the law that prohibited sports betting nationwide except in a few states, regulations allowing Nevada-style sports betting have been adopted in six states. Bills are under consideration in an additional 18 states. In New Jersey, sports wagering revenue was more than 10% of traditional casino revenue in September, suggesting deep demand for legal sports betting.

Thus far, we have seen a number of partnerships, JVs, and license agreements between casino operators, whose gaming licenses enable market access, and a mix of European sports betting operators (primarily William Hill, Paddy Power, and GVC) and technology platform providers. Given an evolving regulatory environment, we believe it will be some time before it becomes clear which investment and operating model is most profitable.

While some U.S. casino operators are more enthusiastic about the opportunity than others, we believe that U.S. operators are taking a measured approach to sports betting by opting for partnerships that minimize their upfront investment in technology, operational expertise, and brand marketing. Driven by the growth prospects of this new market, European operators that have the expertise and knowhow in sports betting are keen to gain a first mover advantage in the U.S. market by joining or acquiring U.S.-based companies. While the U.S. could potentially become the world's largest sports betting market over the next five years, we believe uncertainty over the pace of regulation, tax rates, addressable market size, and profitability are keeping a lid on overly exuberant investment spending.

We continue to believe that the larger and more regionally diversified operators stand to benefit the most from legalized sports betting, as they provide the better value proposition as partners to European sports betting operators, who are likely to continue focusing their efforts on national branding. Although the space is evolving rapidly, because of the focus on partnerships and the restrained investment plans we've seen thus far, we do not anticipate that the credit measures of any U.S. or European operators will be materially affected over the next two years.

2. Regulation continues to weigh heavily on European gaming companies

Recent regulatory actions indicate that the social impact of gambling is garnering more attention, with several changes specifically targeting the reduction of harm coming from addiction to gambling. In May 2018, the U.K. government announced the reduction of maximum stakes on fixed-odds betting terminals to £2 from £100 to reduce the risk of gambling-related harm. This decision will take effect October 2019 and will hit the revenues and profitability of the retail-based gaming companies based in the U.K. for years to come. A second blow came when the government announced that it would increase remote gaming duty (RGD) to 21% from 15% to offset the loss of taxes on gaming revenues. Online gaming is gradually gaining scale and becoming a large part of these companies' activity, so the effect could be significant.

Although gambling regulations have remained broadly unchanged in Germany, several limitations on arcade providers caused a significant reduction in the number of amusement with prize (AWP) machines in 2017 and 2018. However, municipalities have offered hardship exemptions and active toleration until 2021, which has reduced the current impact on arcade operators, but the risk remains. Online casinos have been prohibited in most of Germany since 2011, but many entities operate in Germany under an offshore online license. The lack of clarity regarding the status of online casinos, combined with increased costs associated with regulatory compliance, caused several gaming companies to terminate their activity in the German online market, and other operators could face the same decision soon.

Italy, like Germany, has imposed limitations on arcade operators. New distance laws are forcing many gaming establishments to close, and around 250,000 of the AWP machines in the country (which represent 34% of all machines in the market) have been removed. In July 2018, the newly appointed Italian government announced a ban on advertising of gaming and betting through media channels (including sponsorships) as one of its first steps. This ban will take effect on Jan. 1, 2019. The government also increased gaming taxes (PREU) on AWPs (by 0.35%) and video lottery terminals (VLTs) (by 0.3%), starting Sept. 1, 2018. From May 1, 2019, these taxes will see a small additional rise, with further increases due in Jan. 1, 2020, and Jan. 1, 2021. All those changes are likely to hit profitability of Italian gaming companies, creating more volatility in earnings.

3. A sharp downturn in the global economy in 2019

In a recession, we would expect destination markets, like Las Vegas, to experience more severe declines than local or regional markets, as was the case during the financial crisis. Gaming customers would have less discretionary spending for leisure alternatives, including gaming, and some would likely forgo flights to Las Vegas and spend their gaming budgets closer to home. Additionally, Las Vegas is heavily reliant on business travelers for meetings and conventions, which supports midweek occupancy. A recession would likely lead to a sharp pullback in business travel, which would further pressure cash flow in Las Vegas. Declines in leisure and business travel would likely lead to meaningful declines in room rates across the spectrum in Las Vegas, as operators would still focus on maintaining high occupancy to support out-of-room spending. Although regional gaming revenue and cash flow declines in the last recession were less dramatic than in Las Vegas, we believe in the next recession changes in business models will magnify cash flow declines for regional gaming operators. Since the last downturn, many regional gaming operators have sold all or a portion of their real estate to gaming REITs, and in return, pay a fixed rent payment that can be as much as half of the gaming operator's EBITDAR. As a result, we expect gaming operators will likely experience higher cash flow volatility in the next downturn, even if regional gaming revenue declines are moderate. We also expect that in a recession, all gaming operators will increase promotional spending to try to attract customers and support revenue, and that operators may not be able to remain as disciplined with regard to marketing spending.

Hotels

1. Using leverage for M&A remains a key risk factor

Hotel transactions are up in 2018 and the current trend is strong, with Hyatt selling $1 billion of hotels to Host, Hyatt buying management company Two Roads, Wyndham spending $2 billion on the La Quinta brand and management business, Accor divesting and selling its real estate division for €4.6 billion and acquiring Australian hotel and resort operator Mantra €830 million, Thai hospitality and leisure group Minor International acquiring a 94% stake in NH Hotels for around €2.3 billion, Pebblebrook buying LaSalle, Ryman buying control of Gaylord Rockies, Belmond for sale, and Extended Stay indicating it could separate its real estate at some point.

The length of the current U.S. lodging upcycle is in record territory and our base-case forecast is another year of modest RevPAR growth in 2019, and anticipated supply growth in 2019 is benign partly because the cost of development is rising in terms of materials, labor, and financing costs. As a result of anticipated RevPAR growth and the "buy vs. make" decision favoring acquisitions, we believe conditions are supportive for the hotel transaction market in 2019 to be at least as active as 2018.

The European market is still very fragmented and competitive, with a lot of small independent players ready to sell their business--supported by a strong RevPar growth trend--either to large lodging groups or private equity funds. Several rated lodging companies, including Choice, Accor, and Host, have ample leverage capacity to make acquisitions. The risk factor, as always, is that lodging companies overpay for assets at the top of the cycle and lever up to do so in a manner that weakens credit quality.

2. Ever-present event risk in European travel

Event risks like terrorism, political unrest, natural catastrophes, and weather changes contribute to volatility in the travel industry and could impair the European travel sector in 2019 if they were to occur. They are impossible to predict, but the impact is mostly certain–a temporary decline in demand for travel in affected destinations. 2018 has been a generally favorable year for European travel, as neither major security events nor an incremental worsening of geopolitical risk factors took place during the year so far. However, some travel companies, like tour operators, faced pressure on operating performance from an extremely hot summer, leading travelers to vacation close to home. Airline strikes resulted in flight delays and cancellations, also dampening the willingness to travel.

We believe that in 2019, as long as certain key European holiday destinations remain open, the travel industry should not experience significant shocks, although we will monitor event risks closely. We expect pressure to come from Brexit in March, which will likely affect the demand for outbound travel from the U.K. mostly due to an anticipated weakening of the pound and a slowdown in disposable incomes. This could affect all European travel industry participants in key European destinations, like Spain, Portugal, and Greece (for leisure travelers) and France, Germany, and Benelux (for business travelers).

3. A sharp downturn in the global economy in 2019

While our estimate of recession risk in the U.S. is currently between 15%-20%, risks to our baseline economic forecast include a wind-down of fiscal stimulus in 2019, the potential for inflationary pressure and rising interest rates, and an escalation in trade and geopolitical tensions. In the event the global economy sustains an unexpected shock severe enough to cause a global recession, the lodging industry would probably experience a sharp pullback in business and leisure travel. This would in turn cause a decline in hotel demand that decreases hotel occupancy rates and room rates. As a result, U.S. RevPAR would meaningfully decline, perhaps as severely as the 17% decline in 2009 in the aftermath of the financial crisis. What might partly mitigate this scenario is benign anticipated 2% growth in traditional U.S. hotel room supply in 2019, which should limit the damage to hotel occupancy and RevPAR. However, an untested variable in the supply equation is nontraditional lodging supply like Airbnb. We believe that Airbnb supply is probably highly elastic because it can be listed quickly and in response to a homeowner's economic insecurity due to a job loss, pay cut, or fear of either. The potential increase in overall lodging supply in some markets could shrink hotel occupancy, especially if demand is falling simultaneously because of a sharp global economic downturn.

Cruise

1. Increasing shareholder returns constrain discretionary cash flow

As cash flow has expanded through yield and capacity growth, operators are deploying excess free cash flow into increased returns to shareholders, limiting discretionary cash flow and sometimes leading to borrowing. Notwithstanding high levels of shareholder returns across the three largest cruise operators, we expect all of them to manage returns in a manner that allows them to maintain some level of cushion compared to downgrade thresholds to provide flexibility to withstand weaker-than-anticipated operating performance. However, predicting the inflection point in a cycle is a challenge. We expect operators will pay close attention to pricing and occupancy trends and that the length of the booking curve will provide some warnings ahead of operating weakness. In the event operators observe weakening trends, we expect they will pull back meaningfully on share repurchases to preserve financial flexibility. However, high levels of dividends pose a greater challenge as operators are likely to resist reducing dividends unless necessary. High levels of forecasted capital spending over the next few years coupled with significantly higher dividends compared to prior years are a risk that could compound the deterioration in credit measures in a downturn.

2. Choppy near-term China cruise market

While China remains a long-term potential growth opportunity for cruise operators, we continue to expect the market to remain choppy over the next few years. A sizable and growing middle class with an increasing propensity to travel should support the establishment of cruising as a viable vacation alternative over the long term. However, the cruise industry will need to overcome several challenges, including developing and expanding the sales and distribution network, expanding ports and itineraries, and growing the number of customers who are willing to fly to cruise. Operators are trying to move away from full ship charters where they have less ability to control brand messaging and manage yield and attempting to develop a broader distribution network (including both travel agents and a direct sales channel) where they can better control inventory and pricing. Chinese customers also tend to cruise for a shorter duration than North American or European travelers, which limits the itineraries that cruise lines are able to offer. Additionally, there are fewer customers that fly to ports for cruises, unlike in other markets. Over time, expanding the number of Chinese customers willing to fly to cruise could increase sales opportunities because it will broaden the destinations customers can visit and the itineraries that cruise operators can market to them.

3. A sharp downturn in the global economy in 2019

Cruise operators have a busy ship delivery schedule over the next five years and we believe the major shipyards are operating at full capacity over the next few years. This strong order book, and the need to commit to ship orders as many as five years in advance to secure shipyard capacity, poses a significant risk to cruise operators when a recession occurs. In a recession, net revenue yields would typically deteriorate as customers become more price sensitive and pull back spending on travel. With high fixed costs, we believe it's likely that most cruise operators would offer discounts to support continued high occupancy. Despite deteriorating cash flow, cruise operators would take delivery of new ships because once they have committed to a new build, they lack flexibility to pull back on this spending. As a result, these large advance commitments expose operators to meaningful swings in credit measures if ship deliveries occur during periods of deteriorating cash flows. Operators typically fund 80% of these ship deliveries with debt incurred on the date of delivery, but would increase borrowing to fund any remaining costs if operating cash flow is insufficient to fund the delivery.

Industry developments

Brexit travel disruption

In the event the U.K. leaves the EU in March 2019 with no deal, we believe there are several key risks to the travel sector:

- **Air traffic regulation**. Currently, the U.K. and the EU are in the European Single Aviation Market (ESAM), which allows all airlines owned and controlled by nationals of EU member states to operate freely in the EU, as well as in other countries, like, for example, the U.S. (Open Skies Agreement), via bilateral agreements. A no-deal scenario with no provision for a status quo 21-month transition period would mean that U.K. and EU licensed airlines would lose authorization to provide air services between the U.K. and EU. With no official guidance from the EU or EU National Governments there would be a high chance that U.K. flights to EU countries would be suspended temporarily after March 29, as U.K. airlines would require individual authorizations from national governments for the routes they wish to operate.
- If this occurs, it will inevitably have a negative short-term impact on both business and leisure travelers and ultimately on the operating performance of airlines, tour operating companies, and hotels in countries with high share of U.K. tourists, like Spain and Greece. We would not expect similar disruption in the U.K. because the British government has indicated that it would allow EU airlines to continue to operate.
- **Macroeconomic conditions.** Although not our base case, a disruptive no-deal Brexit scenario could presage a moderate two-year recession. The combination of an initial 15% depreciation in the pound and curtailment in consumer expenditure would further reduce outbound travel from the U.K., as well as curtail travel expenses for U.K. business travelers.
- **Free movement of workers within EU.** After Brexit, EU workers' access to U.K. employment will become more controlled, especially for semi-skilled and unskilled workers. For the travel industry, the most affected companies will be those operating in the hospitality sector, which relies heavily on semi-skilled and unskilled workers. Also, airline crews are very often mixed with pilots and flight attendants being from both the U.K. and the EU. Such limited availability of EU nationals, with further potential complications around mutual qualification recognition, could create a shortage of these workers in the U.K. and increase labor costs for companies.

Macau concession rebidding process could become clearer over the next 12 months

The gaming license rebidding process in Macau remains unclear at this time, although we expect to get greater clarity over the next 12 months. We believe the Macau government values stability, and as a result, we do not expect any existing concessionaires or sub-concessionaires to lose their licenses during the rebidding process. We also do not anticipate the granting of any additional licenses, given the already competitive market conditions and limited land for additional development. We think it's possible that the Macau government could extend the concessions expiring in 2020 to 2022 to conduct a comprehensive and synchronized license rebidding process for all operators. While the gaming license rebidding process is unknown, we believe concession renewals could require some form of economic consideration from operators. This could include a potential upfront payment for license renewal or additional capital investment requirements, particularly in nongaming amenities as the Macau government desires to diversify the revenue base into nongaming sources.

Japan will be an irresistible opportunity for large global gaming operators

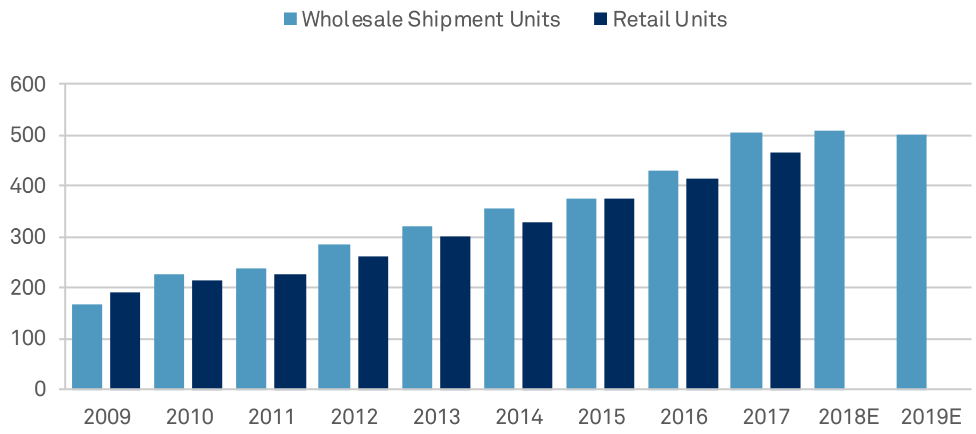
Gaming operators continue to focus on the possibility of securing a license to develop an integrated casino resort in Japan, following Japan's passage this summer of an integrated resorts (IR) implementation bill that would allow three IRs to be built. We expect the process to secure a license will be very competitive given strong prospects for this new gaming destination and the many gaming operators who have expressed interest in pursuing licenses. Large global operators with strong balance sheets and experience operating IRs in existing Asian markets may have a leg up on other competitors because they have already established brand recognition in the region and are better able to finance expected high development costs. However, that will depend on how Japan structures the RFP process and what it elects to emphasize in selecting licensees. In our view, Japan is unlikely to award licenses before 2020 as it needs to lay out the RFP process, provide sufficient time to submit applications, and then review them, which is time consuming. Once a license is awarded, we expect the timeline to build these large IRs will be three to four years. As a result, we believe it's highly unlikely that operators would incur any meaningful development capital spending in Japan before 2021, and that resorts wouldn't be open before 2024.

RV manufacturers' late-cycle production pullback will test capacity management and variable cost structures

A looming risk factor for recreational vehicle (RV) companies is dealership inventory build-up that will probably lead to meaningfully lower shipment growth over the next two years compared to recent shipment trends. We observe that in five of the seven years from 2011 to 2017, industry shipments unit growth outpaced retail sales unit growth. Shipments were particularly strong in 2016 and 2017, which saw shipments unit growth of 15% and 17%, respectively. In terms of absolute units, we also observe that cumulative shipments were higher than retail sales units by about 6% since 2011. We believe this will cause dealers to place fewer orders to RV original equipment manufacturers (OEMs), including Thor and Winnebago, resulting in approximately flat or modestly negative shipment trends at OEMs over the next two years, as dealers work off record shipments in recent years. This will likely cause gross margin compression among RV makers, because their fixed costs will be spread over lower production volumes. In addition, a number of RV OEMs are constructing new production facilities, and this new capacity will ramp up during a period of flattish growth. RV parts suppliers such as Airxcel could also be affected, although potentially to a lesser extent because they have higher exposure to the aftermarket and are therefore less exposed to new unit sales trends. We expect RV makers will be able to cope with the lower shipment guidance, based on our assessment that they have fairly variable cost structures. Their variable costs benefit from a non-unionized labor force, a business model that focuses on assembly rather than heavy manufacturing, and tactical solutions such as de-contenting that can help to recover some gross margin. However, to the extent that profitability underperforms our forecast, which could result from longer-than-expected shipment declines, inflation in labor and other costs, weak retail sales, or uncertain macroeconomic factors such as tariffs, we could indicate rating downside.

Chart 11

North American RV Wholesale Shipment and Retail Units 2011-17 and 2018E-19E ('000s)



Source: RV Industry Association "News & Insights", August 30, 2018; Thor Industries Inc. FY2018 Annual Report

Debt-financed M&A is an additional companion risk factor. Recently, a number of RV companies including Camping World, Thor, and Winnebago engaged in leveraging acquisitions. While these acquisitions generally improved competitive strengths or diversified revenue bases, they are also a source of credit risk. RV companies are highly cyclical, and their credit profiles could rapidly deteriorate if the acquisitions are conducted at high multiples and occur near a potential future downturn.

If toys become targeted by tariffs, Hasbro is better positioned than Mattel

The U.S. has imposed tariffs on another $200 billion of Chinese imports, and tariffs will rise from 10% to 25% in the New Year. Unless the U.S. and China come to a compromise, we believe risks are heightened that the Trump Administration could place tariffs on another $250 billion-plus in goods manufactured in China, at which point nearly every Chinese product sold in the U.S. would be subject to tariffs, including toys. If this were to come to fruition, it could have a negative credit impact on the toy manufacturers, depressing cash flows and forcing changes to the manufacturing base. Currently, toys are predominantly excluded from the list of goods targeted for tariffs. However, according to The Toy Assn. Inc., 85% of toys sold in the U.S. are currently manufactured in China. We believe that if additional tariffs are imposed, toys would almost certainly be added to the list of products targeted, and this would have a negative impact on toy manufacturers' profitability. Hasbro's asset-light manufacturing base and significant cushion in credit metrics compared to our downside ratings triggers positions it well to manage a temporary disruption if it were forced to relocate production lines quickly, and to weather a reduction in free cash flow because of higher tariffs. Mattel, which not only is currently undergoing a significant restructuring and turnaround, but also owns a large portion of its manufacturing base, would have a harder time coping with tariffs. We estimate that a 10% tariff on Chinese manufactured toys sold in the U.S. could raise Mattel's total cost of goods sold in the mid-single-digit percentage area, which we believe the company would be able to absorb, at least temporarily, given significant expected future cost cutting and that the company has already begun analyzing its manufacturing footprint. However, if the Trump Administration were to impose a 25% tariff on Chinese manufactured toys sold in the U.S., Mattel's total cost of goods sold could rise in the low-double-digit percentage area. If potential future tariffs at a 25% rate are sustained and can't be reliably passed on to the consumer, this could force Mattel to relocate manufacturing facilities out of China quickly, which could cause significant disruption to a company already engaged in a significant turnaround and restructuring.

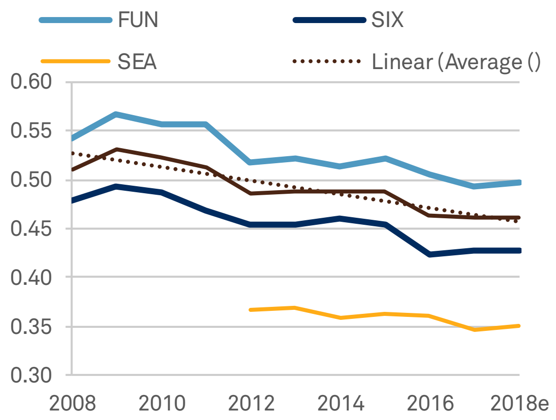
Regional theme park operators are seeking to reduce exposure to seasonality risk

In the past several years, regional theme park operators continued to focus on reducing the importance of the seasonally strongest third quarter by improving attendance, revenue, and EBITDA during the seasonally weak fall and winter quarters. For instance, since 2008 the seasonally strongest quarter's average EBITDA as a percentage of annual average EBITDA declined by roughly a third for North American operators. We understand that U.K.-based Merlin Entertainment observed a similar trend, although quarterly data is not available. Operators have reduced seasonality mostly by focusing on expanding park operating calendars to drive fall and winter attendance by introducing and expanding holiday and winter themed events. Some operators have even experienced the strongest week in the year from expanded events. We believe that over time, theme park operators could significantly mitigate seasonality risk and improve business risks if they can achieve and sustain the seasonally strongest third quarter's EBITDA at less than 50% of annual EBITDA, and if all quarters are generating positive EBITDA on a sustained basis.

However, while park operators may be reducing seasonality, it currently remains a material risk in the space because many parks are located in areas that are not open all year round, predominantly due to cold, winter weather. This reduces these parks' operating calendars to a shorter season, and creates a high risk of adverse weather conditions affecting attendance over a short time frame. While both Cedar Fair and Six Flags have the majority of their parks located in cold winter climates, we view Cedar Fair as more susceptible to seasonality given a higher concentration of parks located in cold winter climates, with over a quarter of EBITDA generated from Cedar Point in Ohio. Additionally, since Six Flags has a year-round membership program and Cedar Fair focuses on its season pass offering, we believe Six Flags has an easier time attracting members to its parks in the seasonally weak quarters, particularly in the first quarter before Cedar Fair's season pass holders decide to renew. This also results in a more stable revenue stream, as annual memberships contribute evenly to revenue through the year, starting in a membership's second year. Merlin indoor attractions, which account for around 40% of EBITDA, help it reduce seasonality risk as well. With SeaWorld's significant revenue concentration across the warmer climates of Florida, Texas, and California, it is the least exposed to seasonality of the three U.S. -based rated peers.

Chart 12

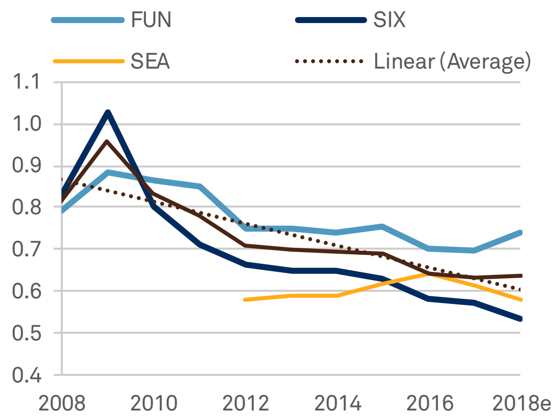
Seasonally strongest quarter as a percentage of annual revenue



Source: S&P Global Ratings

Chart 13

Seasonally strongest quarter as a percentage of annual EBITDA (stock-comp adjusted)



Source: S&P Global Ratings

Canadian casino operators are racing against the economic cycle

Canadian brick and mortar casino operators Great Canadian Gaming Corp. and Gateway Casinos & Entertainment Ltd. are investing heavily in new domestic markets, including Ontario, to fuel future long-term growth. We expect the companies' entry into the Ontario market in particular could improve cash flows and credit profiles for both over the long term. However, we anticipate both to have lower free cash flow generation over the next three to four years driven by heavy capital expenditures of around C$1.5 billion to C$2 billion in the aggregate to refurbish, rebrand, and enhance customer experience to increase the visitation rate in new and underserved markets. Weaker-than-expected performance from newly developed assets could strain cash flow growth at both companies. This could occur due to unfavorable macroeconomic conditions or the companies' inability to generate gaming demand in Ontario. As a result, the ratings trajectory on these companies would depend on their ability to regain sufficient financial capacity to weather future economic stress after a period of heavy investment.

Latin American lodging

The lodging industry in Latin America continues to experience a favorable demand cycle, and we expect stable occupancy rates slightly above 60% and RevPar growth of around 5% for 2019. Most travel destinations are highly competitive compared to those in the U.S. and Europe due to the depreciation of many currencies in the region. Dollar-referenced hotel rates in Latin American destinations provide hotel companies with revenue in a strong currency and a cost structure in local currency, which we believe will benefit profitability over the coming year. The business travel segment is still a growth opportunity for large hotel companies and hotel REITS based on our favorable business environment expectation in the region. Our forecast suggests steady GDP growth of 2.2% for 2019 in Latin America (excluding Venezuela) supporting our view of relatively stable occupancy rates and increasing ADR in line with inflation, driving hotel companies' low- to mid-single-digit growth and solid profitability in 2019. We also expect lodging companies to sustain their expansion plans with the opening of new hotels to be funded with a mix of cash and debt, maintaining moderate leverage and adequate liquidity positions. In addition, if the USMCA trade agreement is approved by legislatures in all three countries, Mexico's corporate sector may benefit from restored investor confidence, which could improve internal business and leisure travel, supporting solid occupancy rates above 60% in both segments. Our top risks for the Latin American lodging industry are related to macroeconomic downside risks and security issues in some markets. If these risks materialize, there is no doubt that they could weigh on lodging companies' operating and financial performance in the short- to medium-term. Moreover, in recent years, nontraditional lodging options such as Airbnb have gained more importance in the lodging industry in LatAm. We believe this trend will increase competition for traditional hotels in most markets in the region. However, compared to mature markets like the U.S. and Europe, we expect the penetration of digital tourism platforms in Latin America to be slow because a significant part of the population still does not have internet access.

Related Research

- Countdown to Brexit: No Deal Moving Into Sight, Oct. 30, 2018
- Consolidation Helps European Gaming Companies Ride Out Regulatory Changes, Sept. 12, 2018
- If Sports Betting Is Legalized, Which Gaming Operators Do The Odds Favor?, April 3, 2018

This report does not constitute a rating action.

Cash, debt, and returns

Global Hotels, Gaming, and Leisure

Chart 14

Cash flow and primary uses

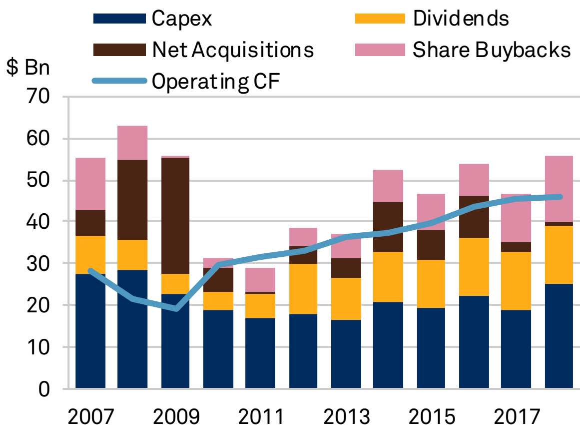


Chart 15

Return on capital employed

Chart 16

Fixed versus variable rate exposure

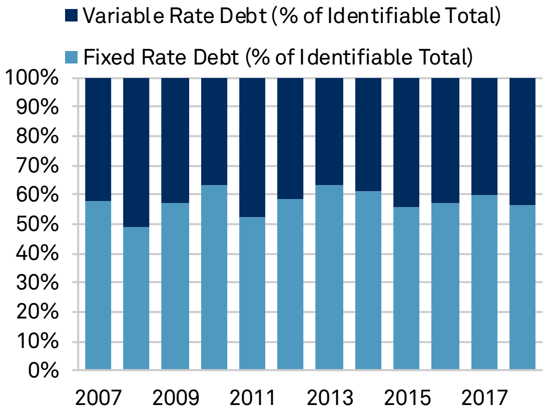


Chart 17

Long term debt term structure

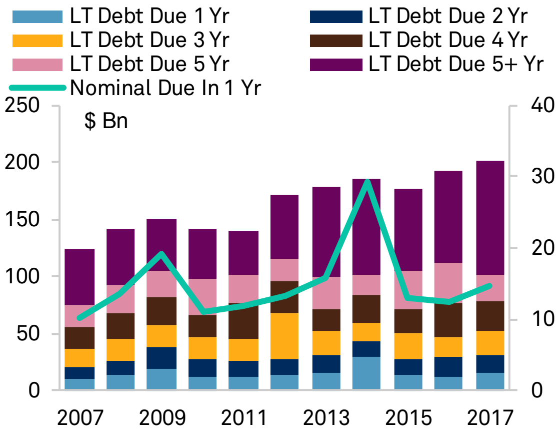


Chart 18

Cash and equivalents / Total assets

Chart 19

Total debt / Total assets

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

spglobal.com/ratings