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Insights Series | Gaming, Leisure, and Lodging

Podcast Transcript

Host (intro):
From Boston Partners, welcome to Insights, in depth conversations with our investment team on investing across geographies, sectors, and industries – beyond what you read in the headlines.

Paul D. Heathwood, CFA Director of Investor Relations:	Well, good afternoon everybody and welcome to the latest edition of Boston Partners Insights. Thank you for joining today. My name is Paul Heathwood. I'm Director of Investor Relations for Boston Partners, and I'm joined today by Paul Donovan. Paul is a fundamental research analyst at the firm who covers the gaming, leisure, and lodging segments of the market. And as a reminder, the purpose of Boston Partners Insights is to provide a discussion with our research analysts on how we evaluate companies and the different inputs that we consider when trying to make investment decisions. Our last Insights call feels like it was a lifetime ago. It was back in February when Paul Korngiebel, our emerging markets portfolio manager provided his look at the initial coronavirus pandemic as it was unfolding in those markets. And obviously he has gone on to spread to the entire world. And it certainly has been quite a year since then, and we hope that you and your families are safe and healthy and remain so. Turning to our discussion today, let's turn the clock back to March and imagine that you were an analyst trying to estimate the value of a casino or hotel business where revenue expectations dropped to zero literally overnight. There is no scenario where a rational actor would project or even model such an outcome. Well, with the possible exception of our colleagues that cover the airline industry, we cannot think of an industry that has been more impacted by the coronavirus pandemic than the gaming, leisure, and lodging sectors. In a world of social distancing and economic lockdowns, businesses that require a physical presence to provide their services are needless to say incredibly challenged. However, as investors, analysts and active managers, we relish the opportunity and challenge of wading into the difficulty, understand how bad things really are, to identify where there may be overreactions, to estimate mispricings in the marketplace, and ultimately to find opportunities. We want to understand not only those firms that have the wherewithal to survive the downturn, but also the firms that we believe can thrive in the aftermath of what will hopefully be a once in a hundred year event. Paul Donovan, welcome to insights and thank you for joining today.
Paul Donovan, CFA Fundamental Analyst:	Thanks for having me. It's certainly been a exciting and interesting year in the gaming, leisure, and lodging space.
Paul Heathwood:	Certainly has, and we have a lot to talk about, so let's dive right in. Maybe we can just start, because they're so dramatic, with some of the numbers and just some of the traffic numbers and other things that help tell how severe things got relative to expectations across your coverage.

Paul Donovan:	Sure. I guess if you rewind back to March, April, when we were really at the height of economic lockdowns and the economy shutting down, relevant metrics across pretty much the entire sector went to zero in terms of hotel occupancy or casino revenues or cruise revenues. So everything, in a pretty unprecedented fashion, declined to nothing. And since then, things have certainly started to recover. And the recovery has been in some cases much stronger than expected and in other cases much slower than expected, and it really comes down to different sub sectors within the sector. And I guess just to put some numbers around where we are now, here six months from the beginning of all this, you'll get an industry like the cruise lines and they're still operating at zero revenues. Things are still 100% down. There are no ships in the water with a few very limited exceptions in other parts of the country outside the U.S. and the Caribbean. So for the most part the recovery really hasn't even started for the cruise lines. Similarly, you look at Macau gaming over in Asia and the recovery has been very slow and measured there largely due to the regulators which have intentionally kept it that way. You look at Las Vegas where recent data has indicated that gaming revenues for the prior month were down about 40%. So certainly has started to recover, but still down significantly. Then you look at something like regional gaming, which is casinos all across the country that depend more so on drive through traffic, and that's been a bright spot in the recovery. Some of those properties actually saw year over year growth last month and for the most part regional gaming has recovered to down just zero to 20% based on August data. And that's certainly exceeded expectations. You look at the hotel companies, again, recent data came out just today indicating that overall domestic hotels are down about 50% in terms of revenue, but there's a huge bifurcation there in terms of the economy side of things and the mid-scale side of things, lower end hotels in suburban locations, which have recovered much faster than very high end luxury hotels in urban centers, which are just not seeing that recovery, are not seeing those core business travelers. And then similarly, you look at the timeshare industry as another entity within the lodging segment, and they have seen some recovery, but it's been relatively slow. They're running at about 50% of revenues as a lot of their business depends on getting prospective buyers into their properties for sales tours and just given a general lack of mobility around people willing to travel. That's been slow to come back. And then to look at the other side of things, one niche within the gaming spaces is online sports betting and igaming or digital casino games, and that portion of the market has actually seen explosive growth throughout the pandemic and they've been the lone beneficiary there as people are at home and still want to do something to entertain themselves. So they're on their phones, they're on their computers and starting to spend more money on things like online sports betting and igaming. So that's one where this has actually been a benefit for them, and they've seen huge growth there. So that's where we stand now. It's certainly been, again, a different story across different aspects of the market.
Paul Heathwood:	Interesting. So, some tough numbers, but raising off to zero, sounds like things are generally getting better in some segments and sounds like actually much better than when they started from in some other segments. Beyond the numbers, how about any anecdotal stories about individual situations in companies or what have you that you find interesting from the last six months?

Paul Donovan:	Sure. I think one of the more interesting aspects has just been that there is clear evidence of pent up demand in terms of consumers do still want to get out there and do things like travel or go to a casino or even go to a restaurant or something like that. So to the extent that they're able to do so as properties have reopened, for the most part we've seen management teams saying that as we were able to reopen the properties, we've actually seen more traffic than we expected and there has been pent up demand and that's been a positive. That's not much of a constellation to somebody like a cruise line where there may be pent up demand there, but because of regulatory issues, they can't actually capitalize on that demand that may still be there because their boats are still in dry dock right now. So that's been one encouraging data point is that people still want to travel. They still want to have these experiences. They seem to understand the public health risks and they're still willing to go to casinos or to go to a hotel. So that's one anecdote that's been interesting on the positive side, and beyond that I think there's been a couple of other interesting data points. I think one has just been that as people come back, they've actually been also willing to spend money. And there's been a number of theories around why that may be, ranging from the effectiveness of stimulus benefits to maybe that there's a demographic shift going on where more younger, affluent people are doing things like going to casinos when they normally wouldn't given that some of their other options are shut down. So there's also encouraging data points that people are willing to go and willing to spend money when they can do so, which is good to see. And then in terms of hearing from management teams, one thing that's also been interesting, more so on the cost side, has been that almost across the board all the management teams I've talked to have been talking longer term about using this huge shockwave to take a really hard look at their cost structure. And they've essentially been forced into doing zero-based budgeting. For the majority of 2020 they've had to cut more costs than they ever imagined and it's given them an opportunity to think about their cost structure really critically in terms of what they really need going forward. So I think there is an argument to be made that some of that may be structural in nature, or at least may extend for a long period of time, multiple years, as there's some learnings from this crisis and people really take a close look at the cost structure and decide that they may not need some of the fat that they had on the business back when things were good and it wasn't such an issue. So those have been some of the anecdotes and I think for the most part they're pretty positive, and I think they give hope to the recovery, though certainly it's going to take a long time, and a lot of that is reliant, obviously, on just the public health trends and hopefully a vaccine soon.
Paul Heathwood:	When you speak with management teams, what kind of timeframes do they have? What kind of timeframe do they have until things really get difficult for them and they face existential crises, whether is it 6 months, is it 12 months? Is it 2 months? What kind of timeframes are you hearing from the management teams?

Paul Donovan:	Yeah, I would say that again, you rewind a five, six months from here and the sole focus from management and really the focus of my conversation with management was around balance sheets and liquidity. And I remember sitting at home at the time doing analysis and a lot of that was just trying to decide, are these companies going to make it with no revenues, burning a lot of cash? And I think what's been good and beneficial has just been that the capital markets have clearly remained open and accommodating to these businesses. You've seen companies raise debt, raise equity as needed, draw down revolvers. There hasn't really been any issues with that and I would say for the most part you look at some of the businesses that are further along in the recovery pathway, like some of the casino companies, even some of the hotel companies that are exposed to the right areas of the market and they're already pretty much cashflow breakeven or better. So there's not a lot of concern there and they're feeling reasonably good about balance sheets. The opposite end of that would be somebody like the cruise lines who are still burning a tremendous amount of cash, as you can imagine. It's quite costly to keep these assets laid up. But even then, all of those businesses have over a year's worth of liquidity, and Carnival Cruise Line's just raised equity last week and it went off pretty much without a hitch. So I think for the most part you haven't seen that financial stress and it seems like there's at least a couple quarters before there's real distress if things continue to be depressed. So I think for now people feel okay about the liquidity and balance sheet side of things, although obviously that would raise to the forefront again if we did see a spike in cases or any other type of lockdowns.
Paul Heathwood:	Okay, great. I want to move the discussion into just defining the industry and getting more into the nitty gritty of what you would do in normal cases, but just before we leave the whole 2020 environment, take us back to March, and you're an analyst, you're now working from home, you have your industry which is falling to pieces with no revenues. What do you rely on? What do you think about? How do you stop from panicking or overreacting in that kind of environment, which no one ever could have expected?
Paul Donovan:	Sure. I mean, I look back and there was some truly crazy days with the market being halted and I had CNBC on the TV and they're talking about apocalyptic scenarios. But, I think what helps us at Boston Partners and as fundamental analyst, is we do take a long-term view and we stick to our three circle investment philosophy, which we always have done. And doing that allows us to really continue to focus on what matters and say, "Look, are we getting a good fundamental business at a good price with positive momentum?" Obviously the positive momentum side of things was quite lacking pretty much across the board at that point in time. But taking that longer-term view allowed us to sit back and say, "Look, this is really bad. 2020 numbers are going to be obliterated. A lot of the normal valuation metrics or fundamental metrics I might look at are almost useless, but taking a step back, taking that two, three, four year view and saying, 'this company has a strong balance sheet. It's going to survive. It's going to, in some cases, maybe even thrive as the industry exits this crisis and the winners get stronger.'" And we were able to look at that and say, "We can still think constructively about the industry and think about where we want to position ourselves by taking that longer term view," and recognizing that clearly there's near-term risks, but by focusing on higher quality businesses, good balance sheets, we're comfortable owning some of those names.

Paul Heathwood:	That's a great recap of the last six months. Let's dive into the industry itself. Can you just take us through, as it's defined, the leisure, lodging, and gaming industry and break down some of the component parts? What the profit drivers are and how they're the same, how they differ. Just give us a good overview.
Paul Donovan:	Sure. So I guess we could start with gaming and I think we tend to think of that in terms of a sub-sector regionally, and you start with... You have the Vegas centric names, those that have the majority of their properties in Las Vegas. Then you also have the regional casinos here in the U.S. that are not located in Las Vegas and are attracting a different clientele, more of a day tripper type versus Vegas, which is relying on people flying in. And beyond just the clientele difference, one important distinction between Vegas and regional gaming is that Vegas is really... It's a gaming market, but it's also a hotel market. That needs to be a profit center for them. Whereas the regional casinos are much more reliant on a somebody showing up on a Wednesday and playing slots for two hours and leaving. So that's Vegas, regional. Also in the U.S. you obviously have this new and growing, call it digital gaming space, in terms of online sports betting, as well as igaming. So companies we've heard of, like DraftKings and FanDuel, that's a very new portion of the business and a very growthy part of the market. So that encapsulates the U.S. region of gaming. Beyond that, the biggest gaming hub would be Macau over in Asia, where you have six operators, a relatively new industry, only a couple of decades old, has been a growth industry over time, but has also been fairly volatile and certainly beholden to the regulators. So that's a big gaming hub in Asia. Beyond that you do have some smaller satellite casinos across Southeast Asia and Australia. Europe is not a huge gaming market. A lot of their gambling tends to happen in bars and gaming halls and for a public equities analyst it's not as relevant. And then there's some small sub-segments of gaming like gaming equipment and lottery companies which participate in the sector as well. But really it breaks down into those regional gaming companies in the U.S., Vegas centric businesses, and then the Macau names. And as you think about the profit drivers across gaming, it's really getting people in the building and getting them to spend money on the gaming floor. And the metric that everybody looks at is gross gaming revenue or GGR, and that's what's reported at... Here in the US it's reported at the state level, and in Macau you get that at a Macau level. So that's really the primary driver. A lot of the costs for these operators are fixed, so they're really looking to drive those gross gaming revenues over time and realize that operating leverage. And then if we move on to, just excuse me, the lodging segment, we tend to think of that... We break that down into by chain scale, which is really in terms of what the room product is that a property offers. So we would look at luxury or upscale as being one chain scale within hotels or mid-scale or economy. So we break it down that way, and as I mentioned before, there's been a huge dichotomy in terms of the recovery this year, where you're not seeing a lot of business travel, you're not seeing a lot of that luxury travel in terms of people coming from overseas. What you are seeing is a lot more activity at the economy level where, for example, it may be a long haul truck driver who is still going to stay at their economy hotel off the highway, because they're already back to business and back to some semblance of normalcy.

Paul Donovan:	So we look at that on a chain scale basis for hotels. We would also break that down by regions in terms of obviously U.S., Europe, Asia, Latin America. Most of the big hotel companies are pretty well diversified geographically. Obviously each one has some different exposure in that sense. And then finally, within hotels an important distinction is just you do have some companies that actually own the property. Some of those are structured as REITs, some of them are not. But you also have a lot of companies that are more of a franchise model, like a Marriott or Hilton where they likely don't own the property, but they're collecting a fee for using their brand and in some cases they're collecting a management fee as well. So there is a distinction in terms of just the ownership versus operator model there. So that's the hotel side. And then also within lodging you could bundle in timeshare, which is a bit of its own animal, bit of a smaller market, largely contained to the US. Profit driver there is really their ability to sell new timeshares, and a lot of that is just relying on getting new prospects into their resorts. And then you move to the miscellaneous leisure side of things. Probably the biggest sub sector there would be cruise lines. Really there's three primary cruise lines globally that participate there. And again, the profit driver for them is they need to fill that ship with people because when they put on an itinerary the boat's going to sail, so they talk about something called net yield, it's essentially a proxy for pricing, and it's a function of really supply and demand. So those are the cruise lines. You also have a couple other very small sub segments within the leisure space, like ski resorts, horse racing, so things like that, where there may only be one or two public companies that really participate there, but obviously still kind of relevant and important to the space. So that's how we categorize everything. I would say the overarching theme is that for the most part companies have pretty fixed cost structures, so a lot of it is just driving that top line, and the top line is really determined by their ability to attract customers and bring people to the property and get them to spend money at the property. And that's obviously what's been so challenging in a year like this because people haven't been doing those things, but that's really the primary profit driver for them is just the ability to grow that top line.
Paul Heathwood:	Let's stick with gaming for a moment. You mentioned the comparison between Las wVegas and Macau, seemingly two of the largest gaming markets in the world. As an investor, what is interesting to you? Why would you like one over the other or how do they compare from an investment perspective?
Paul Donovan:	Sure. Yeah, I would say the biggest difference is that Las Vegas is largely a mature market. If you were to look over the past few years, there's not a tremendous amount of growth in terms of Las Vegas gaming revenues or hotel revenues, and whether or not those stocks that are tied to Las Vegas do well tends to be depending on how the year goes in terms of demand for travel to Las Vegas, which can be determined by the event calendar over there, or even something like weather. So it's generally a pretty mature market, whereas Macau has been around for a little while now, but relative to Las Vegas, much growthier market over time. Macau draws the vast, vast majority of their customers from mainland China, and gaming is still very underpenetrated across that entire region. And as we know that entire region has a growing middle class and things like that, and more desire for travel and experiences.

Paul Donovan:	So Macau is certainly a much growthier opportunity, but you do have more regulatory concerns as well, where there are regulators in Beijing who really are tasked with essentially keeping the market from overheating in some cases, and also making sure that there's no bad actors in Macau involved in anything like money laundering or anything like that. So you have more of a regulatory framework to work within Macau, but over time, you're getting much better growth there, although there is volatility along the way. What's also interesting about Macau is that there's six players in the market. There's only six licenses up for grabs there. I don't expect that to change. So it's really a pretty much an oligopoly. Whereas in Las Vegas, you do need to get a gaming license, but there's much lower barriers to someone building a property on the strip or right off the strip and potentially competing there. So we tend to look at things differently and certainly there's different long-term trajectories there. And obviously there's opportunities to be found in either region, but there are some important differences there.
Paul Heathwood:	You were talking about barriers entry in the gaming industry and DraftKings recently became public and sports gambling is becoming legal in more and more locales. How does that impact the industry?
Paul Donovan:	Sure. Yeah, I think it's certainly been an exciting time for sports betting and igaming or digital casino games. More states have started to legalize these things as, frankly, they start to look for more tax revenue. So you're seeing momentum in terms of regulatory momentum across the United States for these products. And what's really interesting is that for the most part, online sports betting is really not a threat to traditional brick and mortar casinos, and in some cases it's pretty synergistic, where there's data that says a brick and mortar casino that has some partnership with a DraftKings or a FanDuel and co-brands a physical sports book in their casino actually sees an increase in traffic and they're able to access a different demographic in terms of a younger demographic than they might have previously accessed through their existing loyalty program. So sports betting is really... It's a white space and it's a new market. It hasn't really been a bad thing at all for the existing players. And then you have igaming, which is like playing blackjack on your phone, which there is some evidence that that is somewhat cannibalistic to brick and mortar casinos, although probably not as much as expected. And again, it's probably a net opportunity for the gaming companies to look at that space and say, "We can own our brick and mortar properties, but we can also expand digitally, continue to keep in touch with our customers and continue to monetize our customers whether or not they're physically in our property." So I see it as a good thing for the overall industry. And most of the casino operators here in the US are involved in that space in some way, whether they partnered with a DraftKings or a FanDuel, or if they have their own digital offering. So I think that is actually one of the few big revenue growth opportunities from a structural perspective beyond just the COVID recovery that's exciting within the domestic gaming space.
Paul Heathwood:	Wonderful. One of the nichier areas that you spoke about was the cruise lines and ski resorts, and they probably... As you've talked about, their revenues have gone to zero overnight. How do you see those firms recovering and are they interesting investments?

Paul Donovan:	Sure. Yeah, I'll start with the cruise lines. As I said their revenues continue to be zero, and really for them, the key is that they're really not allowed to restart their business and they need to get permission from the CDC here in the US and they also need to have the blessing from local governments all around the world who operate these ports that they're relying on. It's somewhat out of their hands for the cruise lines in terms of when they return. As of right now, the cruise lines have voluntarily suspended cruising until the end of October. My expectation would be that we won't see any cruising happening in 2020, and probably it's more of a phased restart throughout the first half of 2021. So those are certainly interesting names to look at now. I think they're clearly out there on the risk spectrum and also a bit out there in terms of just how the recovery has not even started yet. But the flip side is, as we talked about, they have done a good job of managing their balance sheets. So I do expect they'll be around next year for that recovery, and again going back to something I said at the beginning of the call, there's evidence that there's still good demand for cruising. The companies are still selling future itineraries in 2021, 2022, and people are still booking those. There's still demand to go on a cruise. So I think those companies will recover eventually. It is going to be a slow process and very much reliant on COVID trends getting better, as well as the CDC and other constituents giving them their stamp of approval. So not a clean story at this point in time, but I do expect them to participate in that recovery eventually. And then you mentioned the ski resorts. What's actually interesting there is... It's obviously a very seasonal business here in North America. All of the revenue and more than 100% of the earnings are concentrated in the winter. But the ski resorts have actually just reported some of their best summer numbers of all time because people wanted to get out of the house and they wanted to go to Vail, or they wanted to go to Whistler, even if it just meant hiking and mountain biking. So those companies are actually seeing reasonable trends recently, though looking forward, they will certainly be impacted. They make most of their money on season pass sales for the ski season, and a lot of that is reliant on not locals, but people traveling and there's only so many people you can market to who live in a 50 mile radius in Colorado. They are reliant on air travel. They're relying on people coming into the US from all over the world who want to see these world-class ski resorts, so I do expect them to be impacted this winter. I think the view there is that you would hope that as things continue to trend better, you have a bit of a lost season coming up, but by 2021, they should be in a pretty good position to have a more normal winter ski season then. But thus far, they've done a reasonable job of taking advantage where they can and driving occupancy to their hotels even in the middle of the summer, just because people do want to travel and ski resorts end up being a pretty good way to social distance.
Paul Heathwood:	Excellent. I know we're running a little short on time. I have two quick ones for you. One is, in this downturn, has anything interesting on the short side of your research come about? Not really names, but just things you're looking at for potentially interesting short sales.

Paul Donovan:	Sure. Yeah, I think one thing that's been interesting is, again, going back to something I mentioned at the beginning of everybody looking at their cost structures. There are certain companies, say in the gaming equipment space, that are reliant on casinos spending capex. So if your business is predicated on casinos continuing to invest in spend money, that's probably going to be a difficult environment for you over the next couple of years. Similarly, in the lodging space, as I think about that, my view over the longer term, multiple years, is that the strong get stronger within lodging, within the hotel space, as I think the big branded players that we know about are going to be able to survive and navigate this pandemic. It's really the subscale players who may have a very high geographic concentration in one area that may not do as well, that may not have the balance sheet capacity. So in general, I tend to think that if you were to look out three years across the hotel industry, the big players probably consolidate their power and get a bit bigger, whether that's through M&A, or whether it's just through some of their competitors not surviving. I tend to think that that's the opportunity there in lodging is that you will see some of these hotel players gain share essentially from their subscale competitors.
Paul Heathwood:	Excellent. Well, it's been a great recap of what's going on in the last six months, a great overview of how the industry is shaping up. Do you have any final thoughts before we wrap up?
Paul Donovan:	No, thanks for having me. I appreciate it. It's certainly been a very interesting and volatile year and selfishly I'm hoping that 2021 is a little more quieter and we can focus on the recovery and not have any more quarters of zero revenue and negative earnings, but obviously visibility remains low, but I think overall we've seen some encouraging data points over the past six months and also some interesting stock specific opportunities on our end in terms of how everything has played out.
Paul Heathwood:	Wonderful. Well Paul, thank you for all your thoughts today. Thank you to everyone who dialed in to hear this installment of Insights, and we look forward to speaking to everybody towards the end of the year for our next installment in December.

Paul D. Heathwood, CFA
Director of Investor Relations

Mr. Heathwood is the Director of Investor Relations for Boston Partners. In this role, he oversees the firms portfolio research efforts and distribution efforts in North America. He has held a number of other roles at the firm, including product manager for alternative investments, intermediary sales, institutional sales, client service, and consultant relations. Previous to his sales and client responsibilities, Mr. Heathwood spent five years on the investment team as an equity trader. He was also a founding partner of Boston Partners Asset Management, upon its inception in 1995. Mr. Heathwood began his investment career in 1993 as an equity trader with The Boston Company Asset Management, Inc. Mr. Heathwood holds a B.A. degree in economics from the University of Colorado at Boulder, and holds the Chartered Financial Analyst® designation. He has twenty-seven years of industry experience.

Paul Donovan, CFA
Fundamental Analyst

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