

PRIVATE EQUITY INVESTMENTS IN THE NEVADA CASINO INDUSTRY

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Introduction

There has been much public discussion and media attention regarding the emergence of 'private equity' funds in the casino industry. From 2004 to date, private equity funds have invested in several Nevada gaming companies and there are two announced transactions where existing Nevada gaming licensees seek to be acquired by private equity funds/investors.

Given the activity to date, and the expected continued private equity investments in Nevada casinos, it is appropriate to examine the private equity transactions that have occurred and the regulatory parameters that have been put in place by the Nevada Gaming Commission (the "Commission"), acting upon the recommendations of the State Gaming Control Board (the "Board"). These parameters ensure that private equity investments and involvement are closely scrutinized and furthers the State's public policy regarding gaming.

Private Equity Funds Defined

First, it is appropriate to detail what is a private equity fund.

International Financial Services, London, has defined private equity as "a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock exchange. Private equities are generally less liquid than publicly traded stocks and are thought of as long-term investments."¹

Private equity funds are a means by which investors provide capital to the fund, which then in turn makes such private equity investments on behalf of the investors. Approximately 80% of the investors in private equity funds are institutions pension funds, banks, insurance companies and endowments.² Generally, such funds are structured as limited partnerships, with the investors holding limited partnership interests and the private equity firm/managers

acting as the general partner for the fund.³ The investors are passive investors and have no ability to direct the investment decisions of the

fund. The management of the private equity fund and the fund's investment decisions are made exclusively by the general partners.

According to Private Equity Intelligence, in 2006, \$432 billion in commitments were made to 684 private equity funds.⁴ It has been reported that the draw for investors to a private equity fund is that such funds over the last 10 years have generated a compound annual return of 33%.⁵

Nevada Statutory Basis

When discussing private equity investments in the Nevada casino industry, the question is always raised: "So when did Nevada change the law to allow for private equity investments in casinos?" The answer is, we didn't. Rather, the



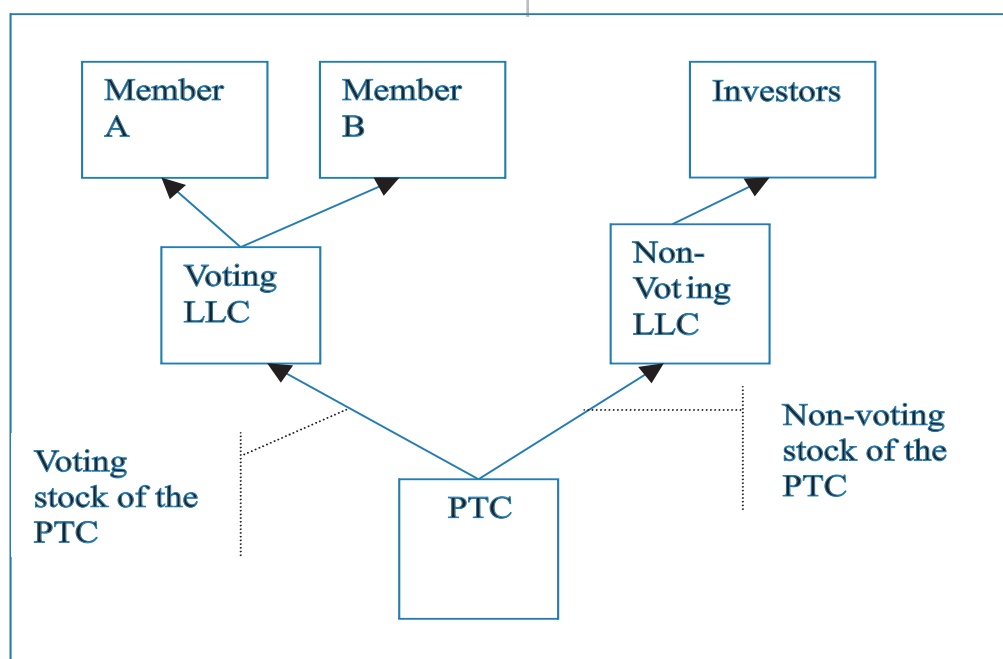
funds changed the structure of their investments to fit within Nevada's statutory and regulatory scheme.

When investing in a publicly traded corporation, Nevada Revised Statute 463.643 provides that it is the holders of voting stock that are subject to licensure.⁶ Holders of non-voting stock in a publicly traded corporation are not subject to mandatory licensure. In order to invest in Nevada gaming companies, private equity funds are willing to split the economic and voting powers of the investment. The private equity fund investors then hold only non-voting stock while the private equity fund managers hold the voting stock of the publicly traded gaming company.⁷

Thus, by (1) splitting the voting and economic powers, (2) investors agreeing to hold only non-voting stock and (3) fund managers agreeing to hold the voting stock and thereby be subject to the licensing requirements of NRS 463.643, the passive fund investors are not in a mandatory licensing position under Nevada law.

Investment Structure

The proto-typical private equity fund investment in a sample publicly traded corporation



(the "PTC") registered with the Commission would be:

Again, the private equity fund invests in and through a "Non-Voting LLC," which only holds

non-voting stock of the PTC. The non-voting stock would have no voting power but would have all the economic rights and benefits that would flow from the particular investment.

The voting power would be held by "Voting LLC," which is owned and controlled by the managers of the private equity fund. These individuals control the investment and are subject to the same full and rigorous investigation by the Board and licensure by the Commission as any individual who is in a mandatory licensing position.

Regulatory Considerations

From the public meetings where various private equity investments have been considered and approved, several considerations by the Board and Commission have become apparent.⁸ First, it is clear that licensure is required for all of those who control the investment and the private equity fund.

When examining the private equity investment structure, the following issues have been examined by the Board and Commission:

- Is the private equity investment being made into a publicly traded corporation?
- Is there a split between the voting and

economic powers?

- Is there full transparency as to who the investors are in the private equity fund?
- Which individuals are controlling the voting

power of the registered PTC?

■ What is the level of independence and sophistication of the person controlling the voting power of the registered PTC?

The Board and Commission also examine the ability of the private equity fund to exert control over a gaming licensee. In this area, the Board and Commission have looked at the experience of the individuals who are managing the gaming licensee and the related operations. As part of the investigative process, the various contractual relationships are examined to confirm that the structure is as represented and does in fact limit control to the select key people who have been investigated by the Board and found suitable by the Commission.

The Commission has accepted that certain organizational rights may be exerted by the private equity funds. For example, decisions regarding the sale of an asset (*e.g.*, the casino), or the filing of bankruptcy, can require approval by the private equity fund managers.

Conditions Imposed

As part of the Commission's approval of private equity fund investments, certain limitations and conditions have been imposed. There are for example, limitations on the transferability of either the PTC stock or the ownership interests in Voting LLC and Non-Voting LLC. Such limitations would require either prior Commission approval or a prior administrative approval by the Board Chairman before any transfer of any such ownership interests.

To monitor that the passive investors are not exerting influence or control, either a new compliance committee is established (or the existing compliance committee is required) to monitor for any such activity. There must be full transparency as to who are the investors in the private equity fund and the licensed individuals must report and seek approval for any changes thereto.

Lastly, in one situation where there was a parent company to the private equity fund, there was a 'stand-still agreement' put in place whereby the parent company agreed not to exert any influence or control over the investment in the Nevada gaming licensee.

Conclusion

When examining private equity investments in the Nevada casino industry, it is paramount that

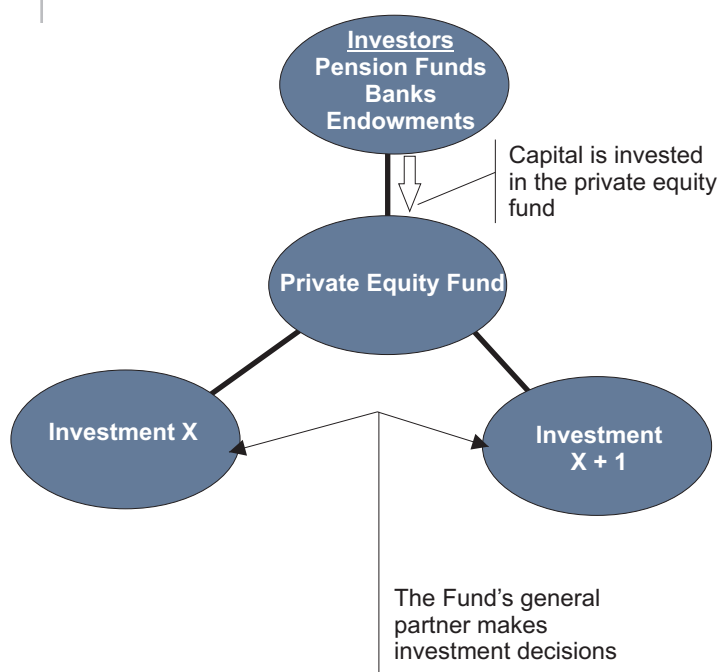
the Board and Commission (1) have regulatory jurisdiction over all relevant decisions makers, (2) examine the total relationship between all parties to the transaction, (3) require full transparency to all investors and (4) license all the individuals who control the private equity fund and its investments in Nevada.

While private equity investments may be new in Nevada, the Board and Commission have treated such investments as an evolutionary step in terms of the form of capital available to the Nevada casino industry. Nevada's regulatory processes and systems have adopted in the past to new forms of capital investments⁹ and there was no reason that private equity funding should not receive similar treatment by the regulators. It is through the thoughtful and strong regulatory oversight that maintains the integrity of the industry and funding sources during this evolutionary process. **NGL**

¹ See generally, Report by International Financial Services, London, "Private Equity City Business Series," dated October 2006, and available at http://www.ifsl.org.uk/uploads/CBS_Private_Equity_2006.pdf

² The 2006 IAGA Conference presentation by Mark Harms, Chief Executive Officer, Global Leisure Partners, L.P.

³ A proto-typical private equity structure would look like:



⁴ Private equity, http://en.wikipedia.org/w/index.php?title=Private_equity&oldid=114581334 (last visited March 13, 2007).

⁵ The 2006 IAGA Conference presentation by Mark Harms, Chief Executive Officer, Global Leisure Partners, L.P.

⁶ It is mandatory licensure for holders in excess of 10% of the voting stock (see, however, Nevada Gaming Commission Reg. 16.430 [waiver for institutional investors to hold up to 15% of the voting stock]) and discretionary licensure for any stockholder with less than 10% of the voting stock.

⁷ Please note that if investing in a privately held business entity, the licensing distinction between holding voting and non-voting stock does not apply. All stockholders of private held business entities are in a mandatory licensing position. See NRS 463.530 (corporations), NRS 463.5735 (limited liability companies), NRS 463.595 (holding companies).

⁸ See, Board and Commission transcripts for the June 2004, August 2004, November 2005, June 2006 and September 2006 public meetings.

⁹ For example, privately-held corporations were statutorily recognized as a funding vehicle in 1967, publicly traded corporations in 1969, limited partnerships in 1979, mutual funds and institutional investors in 1992.



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