Financing Theories and Financing Practices: A Case Study of Two Casino Companies

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ABSTRACT

This paper analyzes the financing behaviors of two major casino companies, Mirage Resorts, Inc., and Circus Circus Enterprises, Inc., in their recent expansion projects. It compares the two companies' financing practices with the three existing financing theories, namely the traditional trade-off theory, the pure pecking order theory, and the modified pecking order theory. It appears that the modified pecking order theory can best describe the two companies' financing behaviors.

Introduction

In corporate finance, what determines the corporate capital structure decision, or the decision about the mix of financing sources, remains an issue without a consensus. Myers (1984) examined the two existing theories about corporate financing, the traditional trade-off (TTO) theory and the pure pecking order (PPO) theory. Myers found that both failed to explain corporate financing behavior satisfactorily. Attempting to solve the capital structure puzzle, Myers proposed what he termed "the modified pecking order" (MPO) financing theory. Therefore, there are at least three theories explaining corporate financing behavior.

Andrew and Schmidgall (1993) have pointed out that the two areas of financial management that concern hospitality managers most are the investment decision and the financing or capital structure decision. Capital structure has a direct impact on the cost of capital and hence on the value of the firm. In hospitality research, nonetheless, capital structure has been insufficiently covered. The studies on hotel capital structure determinants by Kwansa, Johnson, and Olsen (1987) and Sheel (1994); the research on restaurant debt financing by Gu (1993); and a comparison of the capital structure of the hotel industry with those of three slow-growing industries by Gu (1996) are the few documented studies in the area.

The rapid expansion of the gaming industry in recent years has made casino financing mix or capital structure an issue of growing importance. There is, however, a lack of academic studies on the capital structure of casino firms. This paper analyzes the financing practices of two major casino companies, Circus Circus Enterprises, Inc., and Mirage Resorts, Inc., in their recent expansion projects. Comparing the two companies' financing behaviors with the three existing financing theories, the study attempts to identify the theory that can best describe casino financing behavior in reality. The two expansion projects analyzed in this study are the two newly constructed casino megaresorts, "Luxor" of Circus

Circus and "Treasure Island" of Mirage. Both are located in Las Vegas, Nevada, and were launched into operation in December 1993.

Financing theory is a positive theory that explains how a firm's financing policy is determined. It is not a normative theory that would advise what a firm's financing policy should be. The study is not designed to provide any policy guideline for casino firms. The study attempts to find, among the three existing financing theories, the theory that can best explain corporate financing behavior in practice. The purpose of the study is to help hospitality educators and researchers better understand casino firms' financing decision making. Many casino expansion projects have been completed during the recent gaming boom, providing us with good examples of casino financing. Comparing the financing theories with actual corporate financing behaviors, the study can provide real-world evidence for the theories.

Review of the Three Financing Theories

The capital structure irrelevance theory proposed by Modigliani and Miller (1963) holds that a firm's value is not affected by its capital structure. The theory, however, was proposed under some strict assumptions, such as frictionless markets, no tax, no bankruptcy costs, and no growth. On the other hand, the TTO theory of capital structure recognizes taxes and bankruptcies. The essence of the TTO is that a firm's debt-equity decision is based on the trade-off between the debt's tax shield and the costs associated with bankruptcy and financial distress (Robichek & Myers, 1966; Marsh, 1982). According to the TTO, the firm sets an optimal target debt-to-equity ratio at which the marginal costs and marginal benefits of debt exactly offset each other. The firm will gradually move toward the target ratio. Typically, the target debt-equity ratio varies across firms. Companies with plenty of taxable income to shield tend to have high debt-equity ratios. Unprofitable companies may want to rely more on equity financing. Empirical studies attempting to find the determinants of capital structure within the trade-off framework include those by Ferri and Jones (1979), March (1982), and Castanias (1983). Bradley et al. (1984) provided an overall review of the TTO theory and empirical studies. The problem with the TTO theory, as Brealey and Myers (1984) pointed out, is that the theory cannot explain the real-life capital structure phenomenon that the most profitable companies generally thrive with little debt.

Donaldson (1961 & 1969) discussed the principles of the PPO financing theory. The essence of the theory is that a firm follows a pecking-order of preference when making decisions on sources of capital. According to the PPO, internally generated funds are the most preferred, followed by debt if external financing is required. New equity is the last source for financing consideration. There is no well-defined target debt-equity ratio in the PPO. A firm's preference for internal financing, as Donaldson pointed out (1961), is due to its management's unwillingness to be subjected to market scrutiny when raising funds on the capital market. Donaldson (1961) observed that managers strongly favored internal generation as a source of new funds even to the exclusion of external funds, except for occasional unfavorable 'bulges' in the need for funds. He pointed out that if external financing was needed, managers rarely thought of issuing common stocks. Baskin (1989) tested the PPO by analyzing the debt ratios of sample firms and their relationship to past profitability. His

results supported the hypothesis that firms with higher past profitability use less debt financing.

Myers (1984) modified the PPO theory and proposed what he called "the Modified Pecking Order" financing theory. In the MPO, the preference order of financing sources is the same as in the PPO, except that safe debt is preferred to risky debt. The MPO theory differs from the PPO theory on two major issues. First, the MPO suggests that information asymmetry, rather than the management's unwillingness to accept market scrutiny, determines managers' preference for internal financing. Information asymmetry refers to the market's lack of understanding of the true value of a firm's investment opportunities when the firm issues new securities to finance investment projects (Myers and Majluf, 1984). The consequence is the undervaluation of the security and therefore the undervaluation of the firm. The likelihood of undervaluation is related to the riskiness of the security to be issued. The riskier the security, the more likely it is that the market will undervalue the firm. While using internally generated funds can enable a firm to avoid such undervaluation, issuing less risky securities can reduce the undervaluation. As common stock is the most risky security for outside investors, new stock issuance is most likely to cause undervaluation. Therefore, in the MPO, internally generated funds are the most preferred, followed by safe debt, risky debt, and finally new equity.

Second, the preference of debt to equity in the MPO theory is reversible. The MPO emphasizes not only information asymmetry but also a firm's preference for "financial slack" or debt capacity. The firm may reverse the order when its preference for reserving borrowing capacity prevails. Therefore, the firm may move back on the preference order and issue new equity, instead of debt, to maintain or increase financial slack.

In an empirical study, Gu (1996) compared the capital structure of the hotel industry with those of three slow-growing industries: the petroleum and coal products industry, the apparel and textile industry, and the fabricated material products industry. Different leverage ratios were used for the comparison. The results supported the MPO theory.

Operating Features of Casino Firms

The entertainment nature of the casino industry may make the revenues of casino hotels more volatile than those of regular hotels. The casino industry relies more on people's discretionary income than the hotel industry, which caters to a mix of business and pleasure travelers. A negative economic event, such as high inflation that reduces people's real income, may inflict a greater impact on casino revenues. The higher risk of the casino industry was evidenced by its greater beta. According to the financial database of *Prodigy* (1994), at the end of 1994, the average beta of the casino industry was 1.22, compared with the hotel industry's average of 0.79. In the meantime, the casino industry was less leveraged, with an average debt to equity ratio of 0.88, compared with the hotel industry's 1.45. Obviously, the casino industry's greater covariance with the capital market was mainly due to its operational features, rather than its financing features.

The products of the casino industry are risky games. Within the casino industry, casinos offering high-limit games may have more volatile revenues than those offering only

low-limit games because of windfall wins and losses. MGM Grand, Inc., which owns and operates MGM Casino in Las Vegas, had an operating loss in the second quarter of 1995, partly due to a one-night blackjack loss of $20 million to Kerry Packer, an Australian high roller (MGM Grand, Inc., 1995). Caesars World, Inc., which operated Caesars Palace, another giant casino resort featuring high-limit games in Las Vegas, had negative earnings in summer 1994 because of big losses to Asian high rollers (Caesars World, Inc., 1994).

The operation features of casinos imply that the operating cash flows (OCF) of casino firms, and those of high-limit casinos in particular, may be less stable in comparison with those of regular hotel firms. Therefore, a casino firm has to be very cautious if it decides to finance an expansion project with its OCF. A casino firm catering to high rollers is less likely to rely on internally generated cash flow to finance expansion than a casino featuring low-limit games.

The Financing of Circus Circus' "Luxor" Casino Hotel[1]

The "Luxor" project of Circus Circus, Inc., a casino company whose casinos typically cater to low-wager gamblers, is a 30-story pyramid-shaped casino hotel with 2,500 rooms. The construction cost was estimated at $300 million. The project was announced in November 1991 and was started in early 1992. By the end of 1991, prior to the construction, the company had the following financing options for the project.

First, the company could use its internally generated OCF. The company had paid no dividend in the past. All the earnings had been retained for internal financing. Its OCF in 1991, calculated as its net income plus depreciation and amortization, totaled $151.12 million.

The company's earnings and OCF in the previous years (1981–1991) demonstrated a pattern of steady increase (see Table 1), except for a slight dip in EPS in 1986. Its OCF had grown at an average annual rate of 21.7% in the previous 11 years. The steady growth of the earnings and OCF of Circus Circus, Inc., could be partly attributed to the low-limit operation policy of the company. The stable and increasing OCF of the company could be a reliable internal financing source for the "Luxor" project.

The company projected that the monthly OCF during the 1992–1993 period from existing properties would be $10 million to $12 million. In other words, a total of $240 million to $288 million of OCF was expected to be generated for the two-year period. The "Luxor" project was scheduled to be completed in two years. The company's expected internal OCF would be able to cover almost the entire project's costs, $300 million.

[1]Financial information was obtained from the *Annual Reports* (1991–1994) of Circus Circus Enterprises, Inc., *Value Line*, and interviews with the company's officials in charge of investors relations.

Second, new common equity could be a source of financing. The company had 62.5 million shares of common stocks outstanding, with 150 million shares authorized. It could issue more common shares. Prior to the announcement of the "Luxor" project, the company was a favored stock on the market, traded at a price/earning (PE) ratio around 26, well above the S&P 500s average PE of 19. The market condition was favorable.

Third, the company had two existing long-term notes. At the end of 1991, its long-term debt to total capitalization ratio (LTDTC) at book value was 50.87%, which compared favorably with the industry's average of 65.84%. With its debt capacity greater than the average of the industry, the company could issue new long-term debt to finance the project. Additionally, the company had a total of $500 million of bank revolvers, of which the company had used only $247 million. A credit line of $253 million was still available. The large amount of bank credit available to Circus Circus, Inc., was backed up by the company's excellent past and expected future cash flow. According to Fogarty and Killian (1990), one-half of the major insurance companies, banks, and commercial credit companies simply did not accept applications for financing new lodging properties during the 1990–1991 recession. However, should a loan be committed for an expansion project, the project must be supported by the ability to generate healthy cash flow.

The company's decision on financing the project was to rely on internally generated cash flow. It also decided that in case of fund shortage, bank revolvers, which are shorter but less risky than long-term notes, should be used. The company decided not to issue new debt or equity for the "Luxor" project. As scheduled, the "Luxor" casino hotel was completed and had its grand opening in late 1993. The actual expenditure was in line with the initial estimate. No additional external funds were raised for the project. In 1993, during the construction of another project, "Grand Slam Canyon," the company issued $150 million senior subordinated long-term notes, followed by another issue of $150 million debentures. Both issues were for financing needs not related to the "Luxor" project. The company successfully financed the construction of "Luxor" with internally generated funds.

The Financing of Mirage's "Treasure Island" Project[2]

The "Treasure Island" of Mirage Resorts, Inc., a casino company whose casinos are featured with high-limit games, is a 3,000-room pirate-themed casino hotel. The construction of "Treasure Island" had its debut at the beginning of 1992 and was completed in December 1993. The total cost was initially estimated at $430 million. At the end of 1991, prior to the construction, the company had the following financing options.

First, Mirage could use its internal OCF as a part of the financing for "Treasure Island." Table 1 shows its earnings and OCF from 1981 through 1993. The company's operation was

[2]Financial information was obtained from Mirage Resorts, Inc.'s *Annual Reports* (1991–1994), *Value Line*, and interviews with officials in charge of investors relations.

very profitable in 1991, generating $106.14 million of OCF. The company expected to generate a similar amount of OCF in 1992 and 1993, about $100 million per year. Since the project was planned to be completed in two years, internal cash flow would be well below the estimated capital requirement of $430 million. Besides, unlike Circus Circus, Mirage's earnings and OCF had been unstable in the past (see Table 1). During the 11-year period 1981–1991, it experienced four increases and six decreases in annual OCF. In 1989, it had a negative cash flow of $5.38 million. The high volatility of the firm's OCF implied that internal funds would be unreliable financing sources for the project. In comparison with Circus Circus, Mirage's future OCF could be instable and insufficient. External financing was needed.

Second, Mirage could also issue new equity to finance the project. The company had authorized 225 million common shares, with only 47 million shares outstanding. By the end of 1991, Mirage's stock was traded around a PE of 40, even "hotter" than the stock of Circus Circus, Inc. The company could raise new equity in a favorable capital market environment.

Third, Mirage, Inc., had significantly improved its debt capacity through its mid-1991 debt restructuring. Issuing new long-term debt was another financing option. The company's LTDTC was 89.2% at the end of 1990 (see Table 2), which compared unfavorably with the industry's average of 72.35%. In mid-1991, prior to the announcement of the construction of "Treasure Island," the company made two new public offerings of common stocks to bring down its extremely high leverage ratio. The company's LTDTC thus decreased to 72.63% by the end of 1991, compared with the industry's average of 65.84%. The company's financial slack, though still below the industry's average, had been improved.

The company's decision was to issue $300 million first mortgage notes as its primary method of financing the "Treasure Island" project. Internal OCF, estimated at $200 million for the 1992–1993 period, would play a less important role. The notes were collateralized with its three existing casino properties. The new debt was issued in 1992. As scheduled, the "Treasure Island" casino was completed in late 1993. The actual construction cost of the project was $470 million, $40 million higher than the original estimate. The OCF generated from existing operations in 1992 and 1993 totaled $222.1 million. The $300 million raised through issuing notes, combined with the internal OCF, should be sufficient for the project. In November 1993, due to the financing needs for improvements of three existing casinos, the company raised another $170 million through public offering of common stocks.

A Comparison: Financing Theories Versus the Two Firms' Practices

Before the two companies embarked on their new expansion projects in early 1992, their OCFs in the two previous years improved significantly, while at the same time, their leverage ratios dropped. Table 2 shows that the OCFs of the two companies increased while their LTDTC ratios decreased from 1990 to 1992. According to the TTO theory, unprofitable companies would rely more on equity financing, whereas profitable companies may want to have higher leverage to shield taxable income. The fact that the two companies' debt leverage ratios declined as they became more profitable in terms of OCF contradicts the TTO theory. In a longer time frame of 1981–1993, the coefficient of correlation

between OCF and LTDTC was calculated and tested for the two companies respectively. The coefficient of correlation of Circus Circus was –0.16 with a P value of 0.60 and that of the Mirage was –0.41 with a P value of 0.17. The test of the correlation did not support a positive relationship between profitability and use of debt either. The evidence from the two casino companies' financing practices confirmed Brealey and Myers' (1984) conclusion that the TTO theory fails to explain the real-life corporate financing behavior — profitable companies are often found to use less debt.

In financing its "Luxor" project, Circus Circus, Inc., had a clear preference for its internal cash flow, followed by external bank credit revolvers, which was shorter and less risky than long-term notes. New equity was not planned, nor was it issued later. In fact, issuance of new equity had not been considered by Circus Circus as a financing means for years. Relatively risky long-term notes, $150 million senior subordinated notes and $150 million debentures, were issued later in 1993. Both were for other financing needs.

On the other hand, without stable and sufficient expected cash flow, Mirage, Inc., had to rely on external financing as its main financing source for "Treasure Island." The management chose to use secured first mortgage notes, instead of new common equity, for the project. The company did issue new common stocks in early 1991 and late 1993. While the 1991 issuance was entirely meant for debt restructuring prior to the announcement of the "Treasure Island" project, the 1993 issuance served two purposes: financing the improvements of existing properties and further improving the debt capacity.

The two companies' financing decisions showed a clear financing pattern in which internal funds were given the priority, followed by debts, such as bank revolvers, mortgage notes, and unsecured debentures. New equity was not issued for the projects. The financing preference orders of the two companies seemed consistent with what is described by the PPO and MPO theories.

In terms of debt financing, both companies used safe debt first, which was consistent with the MPO theory. While Circus Circus considered bank revolvers in the first place and used risky notes and debentures later on for an unrelated project, Mirage issued only secured long-term mortgage notes for the project. The two companies' preference of less-risky debt to risky debt was obvious and was consistent with the MPO theory.

Both companies showed their desire for maintaining or improving financial slack in their financing behaviors. Circus Circus, Inc., had intended to keep the debt-to-capital ratio low and maintain a healthy financial position. Reserving debt capacity had been a clearly stated corporate policy. In the company's Annual Report (1991), the management indicated that "By design, Circus Circus is well-positioned at the low end of the industry leverage scale, keeping plenty of investment capacity in reserve." The sharp decline in the LTDTC of Mirage in recent years (see Table 2) was indicative of its pursuance of financial slack. The company's 1991 stock issuance, plus the retained earnings generated from its profitable 1991 operation, lowered the LTDTC ratio from 1990's 89.2% to 1991's 72.63%. After its new public offering of stocks in late 1993, Mirage's LTDTC further dropped to 37%. The company's public offerings of stocks in 1991 and 1993 seemed consistent with the MPO's hypothesis that the preference for new debt to new equity can be reversed when the

desire for financial slack dominates. The fact that both companies pursued financial slack and Mirage moved back on the preference order to achieve greater debt capacity supported the MPO theory.

The two companies' avoidance of using new equity to finance the projects was likely due to possible market undervaluation. According to Ehlers (1996), there was a general belief on Wall Street during the gaming expansion that the Las Vegas Market was saturated. When "The Mirage," Mirage Resorts, Inc.'s first megaresort on the Las Vegas Strip, was opened in late 1989, the consensus held that the visitor base was not large enough to support a new megaresort. The same belief prevailed on Wall Street when the two companies announced their plans for the new projects. The two companies' avoidance of new equity financing for the projects seemed to fit the information asymmetry hypothesis of the MPO theory. Using internal OCF, Circus Circus could avoid possible undervaluation caused by the information asymmetry. Using secured mortgage notes could enable Mirage to reduce such undervaluation.

Mirage actually adopted a two-step strategy in financing "Treasure Island." Its first step was to issue new common equity to retire debt in early 1991. The second step was to issue new debt during the construction of the project. The earnings and OCF of the company had been instable in the past (see Table 1). If common stocks had been issued to finance the project in the first place, the security might have been well undervalued because of the risks involved for potential investors. The secured long-term notes, though not risk-free, were much safer for investors. The undervaluation associated with the issuance of the notes, if any, should be less than that associated with a new issuance of common stocks. The information asymmetry hypothesis seems to provide a reasonable explanation for Mirage, Inc.'s strategy.

Conclusions

The two casino companies' financing practices in their new expansion projects do not support the TTO theory. The PPO and MPO theories seem to describe the financing behaviors of the two casino companies better than the TTO theory. There was an obvious preference order in the two companies' financing decisions of their expansion projects. Between the PPO and MPO theories, the evidence leaned toward the latter.

It is inappropriate to generalize the findings from the two casino companies to the casino industry as a whole. As the two firms analyzed in the study are two of the largest casino companies, it is appropriate to conclude that large casino companies do have a preference order in financing their investment projects as suggested by the MPO theory. In financing a project, internally generated OCF is the most favored, followed by safe debt and then risky debt. New common equity is the least preferred, but can be used to achieve financial slack or to increase debt capacity for future debt financing.

Financing decisions are critical to the cost of capital of the hospitality industry and the value of the hospitality firm. Capital structure should be an important topic in the research and education of hospitality finance. It certainly deserves more academic attention. Gu's

(1996) study found evidence supportive of the MPO theory from the hotel sector. This study has provided additional evidence for the MPO from large casino companies' financing practices. However, it is still too early to conclude that the MPO is the theory that can best describe financing behavior in the entire hospitality industry. Future studies may compare the three financing theories with financing behaviors of small casino firms. Furthermore, empirical studies on the financing behavior in the restaurant industry in comparison with the three existing theories are also needed.

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Table 1
Earnings and Operating Cash Flows of the Two Companies
(1981–1993)

Year	Circus Circus Enterprises, Inc.			Mirage Resorts, Inc.		
	EPS	OCFPS	OCF(Mil.)	EPS	OCFPS	OCF(Mil.)
1981	$0.16	$0.23	$22.27	$0.15	$0.21	$41.48
1982	0.19	0.28	27.11	0.14	0.24	41.08
1983	0.23	0.31	34.77	0.22	0.33	59.20
1984	0.28	0.42	47.10	0.05	0.17	29.25
1985	0.33	0.49	55.25	0.13	0.32	49.17
1986	0.32	0.54	61.16	0.02	0.18	31.01
1987	0.55	0.80	90.98	0.03	0.21	23.56
1988	0.76	1.15	104.11	–0.02	0.15	13.11
1989	0.87	1.24	106.14	–0.33	–0.06	–5.38
1990	1.02	1.51	124.53	0.31	1.00	83.46
1991	1.23	1.78	151.12	0.40	0.95	104.36
1992	1.41	1.92	167.60	0.26	0.67	99.90
1993	1.34	2.02	174.30	0.29	0.67	122.20

Note: EPS = Earnings per share.
OCF = Operating cash flow.
OCFPS = Operating cash flow per share.

Source: *Value Line, August 30, 1996.*

Table 2
Operating Cash Flow and Long-Term Debt to Total Capitalization of the Two Companies (1981–1993)

Year	Circus Circus Enterprises, Inc.		Mirage Resorts, Inc.	
	OCF(Million)	LTDTC(%)	OCF(Million)	LTDTC(%)
1981	$22.27	62.56	$41.48	64.04
1982	27.11	53.48	41.08	64.80
1983	34.77	55.36	59.20	60.80
1984	47.10	61.11	29.25	60.12
1985	55.25	54.40	49.17	74.06
1986	61.16	42.76	31.01	67.57
1987	90.98	37.77	23.56	49.58
1988	104.11	67.16	13.11	84.85
1989	106.14	71.76	–5.38	91.12
1990	124.53	72.89	83.46	89.20
1991	151.12	50.87	104.37	72.63
1992	167.60	38.59	99.90	60.02
1993	174.30	50.33	122.20	37.00

Note: OCF = Operating cash flow.
LTDTC = Long-term debt to total capitalization ratio.

Source: *Value Line, August 30, 1996.*