GMI Ratings' Risk List: MGM Resorts International

MGM Resorts International (MGM) is being added to our Risk List due to concerns regarding the quality of its board and compensation policy, its accounting transparency, and its business ethics.

MGM is a Delaware corporation that owns and operates casino resorts. U.S. gaming operations are located primarily in Las Vegas, Nevada, with smaller resorts and hotels in other areas of the country. The company's wholly-owned subsidiaries include Aria, Bellagio, Mandalay Bay, MGM Grand Las Vegas, and The Mirage. MGM derives revenue from business lines including leisure travel, tours, and convention hosting in addition to gaming operations. MGM currently has two reportable segments, one for the 15 wholly-owned resorts in the United States and another for MGM China, which consists of the MGM Macau resort and casino. MGM has owned 51% of MGM China since June 2011, when MGM and Hong Kong businesswoman Pansy Ho completed a reorganization of the capital structure of MGM China. The increase in capital stock gives MGM controlling interest in MGM China, the largest casino in terms of square footage under the MGM brand name.

Tracinda Corporation, a private investment company headed by Kirk Kerkorian, is the principal shareholder at MGM. Mr. Kerkorian, often referred to as the "Las Vegas Baron" and "Casino Titan," is regarded as one of the most important figures in shaping the city of Las Vegas. Mr. Kerkorian bought Mirage Resorts for $6.4 billion in 2000 and Mandalay Bay Resorts for $7.9 billion in 2004, in addition to investing billions in other ventures such as auto companies GM, Ford, and Chrysler. He has also bought and sold the MGM movie studio three times over. Importantly, Tracinda Corporation's stake in MGM has declined rapidly over the past few years. In 2008, the company owned more than half (53.4%) of the outstanding shares at MGM; that figure was nearly halved as of the most recent proxy statement, to 23% of outstanding shares as of December 2011, and was further reduced to 18.7% in February 2012 when Mr. Kerkorian sold 20 million shares of Tracinda's stake in MGM. Mr. Kerkorian also sold 20 million shares last August, and has previously stated he was "evaluating" his investment in MGM. Furthermore, Mr. Kerkorian retired as a director of MGM in June 2011, though he is expected to be named Director Emeritus.

Fiduciary Alert:
Investors subject to a fiduciary standard should evaluate their positions, rebalance or hedge as necessary, or be prepared to justify a decision to hold companies receiving this designation.

ESG: Measuring Risk

GMI Ratings has combined our ESG research with the closely related field of forensic accounting risk analysis. Accounting transparency is a critical measure of the extrafinancial risks that have been predictive of many corporate blowups.

Traditional fundamental financial analysis does not fully address the quality of financial disclosures, or the broader set of risks addressed through ESG research.

Many notable corporate failures have been driven by non-financial issues. Our research identifies areas where management is not adequately addressing risks, or has interests that are not aligned with long-term performance and sustainability.

The "F" Rating

GMI Ratings assigns ESG Ratings to approximately 4,300 of the world's most actively traded companies. They are summarized through our ESG KeyMetrics, where red flags highlight at a glance for investors those factors we believe are most likely to have a material impact on investment returns. Not more than 5% of these companies will receive our lowest rating of "F." These companies are assigned an F rating only after analytical review.

Our process to identify the F-rated companies included analysis to identify accounting items associated with fraudulent financial statements, as well as those corporate governance factors most indicative of a disconnect between management and investor interests.

This approach provides an especially powerful means for identifying and managing ESG risks: comprehensive review of corporate governance and other sustainable investment concerns plus an equally effective assessment of accounting aggressiveness and transparency risks.

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MGM lists substantial indebtedness and significant financial commitments among the risk factors in its most recently filed 10-K statement. As of December 31, 2011, MGM listed approximately $13.6 billion of debt. Contributing to this indebtedness, as well as to multiple unresolved legal proceedings, is the failed CityCenter construction project.

The CityCenter construction project in Las Vegas, the most expensive privately funded construction project in U.S. history, was originally planned as a 49-story building with about 200 condominiums atop 400 hotel rooms. When county officials found "significant" construction errors associated with 14 floors of the CityCenter unit, the condominium portion of the project was scrapped. Consequently, there is ongoing litigation between MGM and the contractors involved in the building of CityCenter. The general contractor for the development project, Perini Building Company, Inc., filed a lawsuit in March 2010 against MGM MIRAGE Design Group and certain subsidiaries of CityCenter Holdings, LLC. Perini asserts that the project was mostly completed and could be finished safely, but that the defendants failed to pay the company approximately $490 million under the construction agreement for labor, equipment, and materials. Further, the complaint alleges the defendants failed to provide complete and timely design documents, delivered design changes late, and obstructed Perini's ability to complete the project, ultimately culminating in breach of contract and fraud. A trial date of February 4, 2013 has been set to consolidate lawsuits involving Perini, remaining Perini subcontractors, and related third parties.

MGM's most recent 10-K also lists six separate shareholder lawsuits filed in Nevada federal and state courts in September and November 2009 concerning securities and derivative litigation involving CityCenter. The lawsuits are against MGM and various former and current directors and officers, alleging breaches of fiduciary duties and federal securities laws violations during the period from August 2007 through the filing of the lawsuits. The lawsuits assert that defendants artificially inflated MGM's stock price by knowingly making materially false and misleading statements about the company's financial condition, including operations, CityCenter, and the intrinsic value of the company's common stock. The lawsuits further allege that these misstatements and omissions allowed company insiders to profit from the sale of company stock to the public, caused plaintiffs and other shareholders to purchase MGM stock at artificially inflated prices, and that MGM implemented a share repurchase program to the detriment of the company.

"[S]ix separate shareholder lawsuits... assert that defendants artificially inflated MGM's stock price by knowingly making materially false and misleading statements about the company's financial condition."

Board composition is also a significant concern. The company's principal shareholder, Tracinda Corporation, has two directors on MGM's board who could have interests which differ from other holders of MGM stock. These directors also have the ability to provide significant influence on policy issues. For instance, 40% of the Compensation Committee is currently comprised of members of Tracinda's management team, including the committee chair. The chairman of MGM's Compensation Committee is Anthony Mandekic, who has served as Treasurer and Secretary of Tracinda Corporation since its inception in 1976. Mr. Mandekic sits on four of five board committees in total, including the Executive Committee. Also occupying a seat on MGM's Compensation Committee is Daniel Taylor, an executive of Tracinda Corporation since 2007. Mr. Taylor is also on the Executive Committee and serves on three of five MGM board committees.

The composition of the Compensation Committee leaves much to be desired even aside from the presence of Tracinda's representatives. The independent directors of the Compensation Committee include Rose McKinney-James, whose functional independence may be compromised by the fact that she previously served as a director of Mandalay Bay for six years prior to its being acquired by MGM in April 2005. Independent director Willie Davis has served on the MGM board for 23 years, a period of time which in itself often

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compromises objectivity. There are also concerns regarding the quality of Mr. Davis' past and present board service at other firms. Mr. Davis received over 13% withhold votes (an above-average level) at his last election at Fidelity National Financial, Inc., where he currently serves on the board. In addition, he served on Kmart's compensation and nominating committees for a number of years preceding the company's January 2002 Chapter 11 filing. The final member of MGM's Compensation Committee is a 90-year-old independent director who has served on the board for 12 years.

Additional issues with the board include the presence of lead director Roland Hernandez, who serves on the Executive Committee and as chairman of the Audit Committee. Mr. Hernandez served on the Lehman Brothers board as a member of its Finance & Risk Committee beginning in 2005, about three years before the company's spectacular collapse. Mr. Hernandez currently sits on 4 public boards, holds 11 committee appointments, and received 12% of votes withheld upon his most recent election to the board of Vail Resorts, Inc.

"[L]ead director Roland Hernandez...served on the Lehman Brothers board as a member of its Finance & Risk Committee beginning in 2005."

Regarding compensation, shareholders lent just 78% approval to MGM's advisory vote on executive compensation, meaning more than 20% of shareholders were not in favor of the policy. CEO James Murren received fiscal 2010 total summary compensation (TSC) worth over four times the median TSC for the other named executive officers. This figure includes compensation not linked to performance including a base salary of $2 million, which is twice the IRC tax deductibility limit; perks of $585,274, including $374,514 for personal use of company aircraft; and a discretionary bonus of $750,000. Indeed, Mr. Murren's discretionary pay elements were granted even as shareholders experienced losses. While MGM's three-year returns are positive, there is pending litigation, discussed above, regarding alleged stock price inflation over this period; furthermore, the company has underperformed industry peers.

The discretionary bonus received by Mr. Murren for fiscal 2010 was just one of two bonuses received by the CEO. He also received an annual cash bonus worth more than $4.3 million based on EBITDA performance goals. In fact, not only does the CEO receive annual incentive awards based on EBITDA performance goals, but he is also eligible to receive additional cash awards and performance-based restricted stock units based on EBITDA goals measured over six-month performance periods. This compensation arrangement pays executives twice for achieving the same performance metric, and encourages focus on extremely short-term growth.

Finally, MGM's growing interest in China may concern shareholders. Most notably, the company's key partner in Macau, China is Hong Kong businesswoman Pansy Ho. Under the Nevada Foreign Gaming regulations, regulators make a determination as to whether a business relationship can potentially harm the reputation of the state. In 2007, the Nevada Gaming Commission conducted an investigation of the relationship between Pansy Ho, her father Stanley Ho, and the MGM Mirage, and concluded that MGM's Nevada gaming activities may continue. However, an investigation by New Jersey officials went differently. The New Jersey Division of Gaming Enforcement released a report in May 2009 which found the joint venture in China to be unsuitable and directed MGM to terminate its relationship with Ms. Ho because she has ties to Chinese organized crime. This issue has also drawn an investigation by the Illinois Gaming Commission, which concluded that Ms. Ho and her father have extensive links to Chinese criminal gangs, which Mr. Ho, who is considered the father of modern gambling in China, allegedly allows to operate freely within his casinos.

The New Jersey Division of Gaming Enforcement further concluded that MGM Mirage

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knowingly signed on with a partner the company knew was unfit in order to operate in China. According to a report in the Wall Street Journal, " 'From the beginning of its efforts to enter Macau, MGM pursued partnerships with persons that it knew were associated with those aspects of gaming in Macau most heavily penetrated by organized crime,' New Jersey's Division of Gaming Enforcement wrote in a previously confidential report to the state's Casino Control Commission." As a result of their investigation, casino regulators in New Jersey asked MGM to either sell its 50% stake of the Borgata Hotel Casino & Spa or terminate its relationship with Ms. Ho. In March 2010, MGM chose to divest its interests in the Borgata and end operations in New Jersey rather than disengage from Ms. Ho. However, MGM has had trouble unloading the asset, and recently received an extension until March 24, 2013 in order to complete the sale of its holdings.

"MGM pursued partnerships with persons that it knew were associated with those aspects of gaming in Macau most heavily penetrated by organized crime."

The MGM China relationship is also a current driver of concern regarding the company's accounting transparency. MGM's 2010 acquisition of an additional 1% of MGM China gave it a controlling interest and triggered a requirement to consolidate MGM China's accounts with MGM's. A $3.5 billion gain was recognized upon consolidation as unusual income and served to reduce operating expense by about 60%. Although the consolidation was necessary, it serves to obscure comparisons in true operating revenues and expenses. Moreover, approximately $7 billion of the $7.5 billion fair value of the acquisition was attributed to goodwill and intangibles, substantially decreasing the quality of MGM's balance sheet as total intangibles rose from 2% to 29% of assets. Although total equity increased by $3.5 billion, making the company appear less leveraged, in fact we do not believe there was any real improvement in this regard. As noted above, the company's own recent filings note a high level of indebtedness. Moreover, although the company's accounting profile is currently greatly affected by the MGM China consolidation, we note that MGM's accounting practices have been rated "Aggressive" or "Very Aggressive" according to our Accounting and Governance Risk (AGR) rating for the last two-and-a-half years (since September 2009).

In sum, these varied concerns indicate a serious degree of potential investment risk, and suggest that investors should subject the company to heightened levels of scrutiny or engagement.

Top Institutional Holders *(Source: Yahoo! Finance. Does not include direct holders)*				
Holder	**Shares**	**%**	**Value***	**Reported**
Janus Capital Management, LLC	46,357,631	9.48	483,510,091	Dec 31, 2011
Paulson & Company, Inc.	37,417,600	7.65	390,265,568	Dec 31, 2011
Vanguard Group, Inc. (The)	13,564,607	2.77	141,478,851	Dec 31, 2011
Wellington Management Company, LLP	10,721,059	2.19	111,820,645	Dec 31, 2011
Marathon Asset Management LLP	7,824,558	1.60	81,610,139	Dec 31, 2011
BlackRock Institutional Trust Company, N.A	7,742,851	1.58	80,757,935	Dec 31, 2011
AllianceBernstein, L.P.	6,550,644	1.34	68,323,216	Dec 31, 2011
State Street Corporation	5,353,130	1.10	55,833,145	Dec 31, 2011
Susquehanna International Group, LLP	5,214,979	1.07	54,392,230	Dec 31, 2011
Dimensional Fund Advisors LP	5,128,929	1.05	53,494,729	Dec 31, 2011

*Value shown is computed using the security's price on the report date given

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