It wouldn't be wise to sit down at a table in Las Vegas without understanding the rules of the game you're about to play. Similarly, it's important to understand the rules that govern the gambling industry before you choose to buy gambling or casino stocks. We've laid out a few steps for you to bear in mind as you consider investing in the casino market.

1. Understand what part of the casino you're betting on.

2. Know the end customer that will drive demand.

3. Determine if regional dynamics drive demand.

4. Regulators may have more control over your investment than you think.

5. Understand how innovation and suppliers impact your stock.

6. Make sure the casino stock fits your risk profile.

7. Be willing to acknowledge how it could all go wrong.

Image source: Getty Images.

Let's start with the games themselves. Casino operators don't develop the slot machines or table games that are in their casinos; they leave that to companies like **Scientific Games** (NAS DAQ: SGMS)
and
International Game Technology

(NYSE: IGT)
. After years of consolidation, these are the two biggest gambling suppliers in the industry, building everything from slot machines to shufflers and back-end gaming systems. Suppliers operate in a regulated environment, just like casino operators themselves, so the business is difficult to disrupt from the outside.

One area of supply that these companies are trying to push into is online gambling. Online gambling has been a topic of conversation in the casino industry for more than a decade, and after a number of challenges, most of the legacy big names in the space like PokerStars and Full Tilt are now owned by **The Stars Group** (NASDAQ: TSG).

In highly regulated markets like the U.S., most of the time, customers won't just be able to gamble directly with Full Tilt or other online-only companies. There will be a casino company that owns the gambling license, and someone else will offer the back-end technology as a service to take bets. Scientific Games, IGT, and The Stars Group have all built partnerships with casinos to this effect. Whether it's online or in a casino, there's likely a supplier building the game you're playing and not the casino itself.

Though there are many types of companies within the gambling industry, public attention sways toward casino-owning organizations. **MGM Resorts** (NYSE: MGM), **Caesars Entertainment** (NASDAQ: CZR)
, and
Las Vegas Sands
(NYSE: LVS)
are three of the biggest casino companies in the world, lending them great visibility on the stock market as a whole. But there are also regional players like
Boyd Gaming
(NYSE: BYD)
and
Penn National Gaming
(NASDAQ: PENN)
that have exposure to regional markets like Iowa, Mississippi, and Indiana. They might not be flashy, but they're consistent revenue generators around the country.

In Las Vegas, MGM Resorts and Caesars Entertainment are the biggest names in town. The two companies own a majority of the casinos on the Las Vegas Strip, and their results rise and fall with the region
. Both companies also own a large number of regional resorts across the U.S., so they're not a

pure play on Las Vegas, for better or worse.

While Las Vegas gets a lot of attention in the U.S., Macau and Singapore are far more attractive for casino operators financially. Las Vegas Sands has the biggest market share in Macau's $37.6 billion gambling market, and it has one of only two casinos in Singapore. **Melco Resorts** and **Wynn Resorts** are the two other companies with most of their revenue coming from Macau, and if you're looking at gambling markets, that's really the place to be.

Bear this in mind about casino owners: The casino floor itself isn't their only revenue generator. Las Vegas Strip resorts generate more than half of their revenue away from the casino floor -- gathering money from hotel rooms, restaurants, bars, conventions, and of course shopping. Wynn Las Vegas, for example, attracts some of the biggest gamblers in the world, yet it still only generates 25% to 30% of revenue on the casino floor. Nongaming revenue is critical, especially for resort operators in the U.S.

REITs

The final group to know in casino investing is REITs. They own the land and property on which casinos operate and are a relatively new phenomenon in the industry. There are three big players to know: **Gaming and Leisure Properties** (NASDAQ: GLPI), which is associated with Penn National; **MGM Growth Properties** (NYSE: MGP), linked to MGM; and **VICI Properties** (NYSE: VICI), which is tied to Caesars Entertainment.

These REITs collect regular rent from casino operators, providing investors with a slightly lower-risk way to invest in the industry. Rents are usually tied slightly to resort revenue, giving a little upside if the industry grows, but the real benefit is regular dividends from the gaming industry.

2. Know the end customer that will drive demand.

Companies have very different demand drivers, depending on where they are located geographically and how they fit into the supply chain.

In Las Vegas, gambling and noncasino revenue is driven by tourists who visit from around the U.S. and the world. There are high rollers that help any given resort, but overall it's the 40 million visitors to Las Vegas each year that keep the city running. In that sense, the overall economic condition of the U.S. is particularly important for casino owners. If a recession hits, as it did in 2008, the entire industry can fall on hard times.

Across the Pacific Ocean in Macau, the market is driven primarily by high rollers, or VIPs . Two-thirds of the region's gambling revenue comes from VIP baccarat tables, which creates a market that can ebb and flow very quickly. Las Vegas and Macau are serving customers with entertainment and gambling, but they're often serving very different customers.

Casino suppliers, on the other hand, are selling to the casino operators themselves, so their incentive is in seeing gambling expand around the world. They've ridden a wave of new casinos in Asia and the U.S. over the last two decades, and that's helped them grow.

REITs make most of their income from rent payments from casino operators, but those rent rates are sometimes tied to revenue growth at the casino. Over the long term, their incentive is to see casinos be successful, even if they aren't taking the bets themselves.

3. Determine if regional dynamics drive demand.

Some companies have regional dynamics that determine the success or failure of a casino. Knowing how the surrounding region impacts your investment is more important than you might think.

For example, when China began a crackdown on corruption and money laundering in 2014 , it hit Macau casino stocks hard. The region's casino revenue fell by about half, and the loss of VIPs was the primary reason for the drop. In Macau, regional friction between Macau and China comes with the territory, and that's something investors need to understand.

In the U.S., we've seen a rapid expansion of casinos across the East Coast and Midwest, which has had an impact on casinos across the country. Atlantic City's total casino win peaked in 2006 at $5.22 billion and dropped as low as $2.56 billion in 2015. Aging casinos can be blamed for some of the losses, but new casinos in Pennsylvania, Connecticut, and Washington, D.C., have increased supply in the region, which hurts Atlantic City.

4. Regulators may have more control over your investment than you think.

Casinos are among the most regulated businesses in the world, and those regulators hold a lot of power over investment. In new casino markets, like Japan, regulators make the choice of who wins a concession to build a casino and who doesn't. Las Vegas Sands' massive success over the past two decades can be traced back to winning concessions in Macau and Singapore, which generate the vast majority of the company's revenue. On the flip side, Caesars Entertainment's struggles can be largely attributed to the fact that it couldn't win a concession in Asia.

But it isn't just getting new licenses that is important; investors should watch to make sure casinos are keeping their existing ones. Macau recently extended MGM's gambling license through 2022, which is when Las Vegas Sands, Wynn, Melco Resorts, and Galaxy will all need to re-up their permits.

5. Understand how innovation and new suppliers impact your stock.

Competition can come from surprising places in the casino industry. This means you as an investor must keep an eye on myriad factors -- including some that you may not expect.

In the supplier space, I do not see a huge threat in new slot machine or table game makers, but I do detect a formidable foe in electronic gambling. States across the U.S. are opening up betting on sports and horse racing, and mobile betting is often being included in legislation that allows expanded gambling. The biggest threat to casino game suppliers may ultimately be electronic game suppliers that take people off the casino floor.

When it comes to casinos themselves, the biggest risk is states allowing more casinos. We've seen many jurisdictions like Massachusetts and Washington, D.C., open up casino gambling in

order to raise revenue. As the supply of casinos increases across the country, it dilutes the value of each existing casino. This impacts everyone from big names like MGM Resorts and Caesars Entertainment to Boyd Gaming and Penn National Gaming.

Regulators often hold the keys of supply in the casino industry, so they can drive both individual risk for casino companies and industry risk if they decide to increase supply.

6. Make sure the casino stock fits your risk profile.

Casino stocks aren't for everyone, so investors need to make sure that stocks fit their risk profile.

The highest-risk segment of the market isn't casino operators but rather suppliers, who have a lot of operational leverage. If casinos stop spending on new equipment, they will be left in the dust.

Casino operators themselves are next riskiest, and they'll rise and fall depending on everything from regional gambling dynamics to macroeconomic trends. We don't need to look any further than the rise and fall of Macau's casinos' stocks from 2012 to 2015 for evidence of how quickly fortunes can change in the casino market.

The least risky way to play the industry is through gambling REITs. They generate revenue from rent paid by casino operators, so unless a company goes out of business, they have relatively low risk. The business is riskier than some other REITs, but it's the lowest-risk way to bet on casinos today.

7. Be willing to acknowledge how it could all go wrong.

Casino stocks can be extremely volatile, and understanding how an investment can be a big winner or loser is key to investing in the industry. Evaluate whether regional dynamics will cause a rise or fall in your company's fortunes and what drives regional demand.

Leverage is also important to understand, because casinos are traditionally highly leveraged

companies given their big up-front costs. Some operators with strong cash flows have reduced debt and even started paying dividends, but others are taking on more leverage to acquire competitors and expand their geographic footprints. Leverage is the one thing that will kill a casino company in a downturn, so understanding its risks is important.

Investing in casino stocks can be both entertaining and lucrative when done well. History has shown that casino stocks can wildly outperform the market when conditions are right, but many companies have also gone bankrupt, so this is a sector for the adventurous investor.

How a casino stock hits the jackpot

The wild card for casino stocks is their opportunities to expand into new jurisdictions. Las Vegas Sands, Wynn Resorts, Melco Resorts, and MGM Resorts hit a jackpot when they were granted gaming concessions in Macau, and Las Vegas Sands won big again when it won the license to build one of two casinos in Singapore. But since then, there have been few big growth opportunities.

That'll change soon, as Japan plans to open multiple gambling licenses to the industry. It's not clear who will win the opportunity to build there, but estimates have put the country's gambling market at potentially $10 billion to $40 billion per year . That would dwarf the $6 billion to $7 billion in gambling revenue on the Las Vegas Strip and could come close to the $37.6 billion Macau casinos generated in revenue during 2018.

Japan is the only huge new market on the horizon today, and the company/companies that win a casino license there would see a windfall for decades to come.

Casino stocks are the new Dividend Kings

Let's end with the most dramatic shift in casino stocks since 2010: the introduction of dividends. For decades, casino companies would literally bet their futures to build new multibillion-dollar resorts, stretching every dollar they could to build bigger and better properties. That's what built the Las Vegas Strip, Macau, and Singapore into the markets we know today. But the building boom has slowed, and the money from existing resorts keeps coming in, leaving some companies flush with cash.

Las Vegas Sands, Wynn Resorts, MGM Resorts, and Melco Resorts are four of the biggest names to start paying dividends. Given their cash flows each quarter, they are arguably some of the best dividend stocks on the market
.

Investors may not come to the casino industry for dividends, but large quarterly payouts make a fine reason to stick with some of these stocks for the long term.

Travis Hoium owns shares of Wynn Resorts. The Motley Fool recommends Gaming and Leisure Properties and Las Vegas Sands. The Motley Fool has a disclosure policy .

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