CHURCHILL DOWNS INCORPORATED

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Churchill Downs 2008 First-Quarter Conference Call Transcript

Operator
Good day, ladies and gentlemen, and welcome to the first-quarter 2008 Churchill Downs earnings conference call. My name is Jeremy, and I will be your coordinator for today. At this time all participants are in a listen-only mode. (OPERATOR INSTRUCTIONS.) At this time I'd like to turn the presentation over to your host for today's call, Ms. Julie Koenig Loignon. You may proceed, ma'am.

Julie Koenig Loignon - *Churchill Downs Inc. - VP Communications*
Thank you, Jeremy. Good morning and welcome to the Churchill Downs Incorporated conference call to review the company's results for the first quarter of 2008. The results were released yesterday afternoon in a news release that has been covered by the financial media. A copy of this release announcing results and any other financial and statistical information about the period to be presented in this conference call, including any information required by regulation G, is available at the section of the company's Web site titled Company News located at www.churchilldownsincorporated.com. Let me also note that a news release was issued advising the accessibility of this conference call on a listen only basis via phone and over the internet.

As we begin, let me express some statements made during this call will be forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are statements that include projections, expectations or beliefs about future events or results, or otherwise are not statements of historical fact. The actual performance of the company may differ materially from what is projected in such forward-looking statements. Investors should refer to statements included in reports filed by the company with the Securities and Exchange Commission for discussion of additional information concerning factors that could cause our actual results of operations to differ materially from the forward-looking statements made in this call.

The information being provided today is of this date only and Churchill Downs Incorporated expressly disclaims any obligation to release publicly any updates or revisions to these forward-looking statements to reflect any changes in expectations. Members of our executive team are here and will be available to answer questions after some formal remarks. We'll begin now with our president and chief executive officer, Bob Evans.

Bob Evans - *Churchill Downs Inc. - President, CEO*
Thanks, Julie. Good morning everyone, thanks for joining us.

All us here at Churchill Downs have been devastated by the Eight Belles tragedy. None of us can recall seeing an accident such as that, and our people have seen a lot of horse racing over the years. Our sympathies go out to her breeder, owner, trainer, her jockey, her groom and all her connections. We don't know what the actual cause was. And those who have already opined on the topic don't either. They're just speculating. Perhaps we'll never know. But we are hopeful the research currently underway in various academic and other organizations plus the actual real-world experience we're gaining at our track Arlington Park, which put in the synthetic Polytrack surface prior to last year's meet, and other tracks will show us the way to safer racing for both horse and jockey. Frankly, it's been hard to focus on pulling the information together for yesterday's earnings release and today's conference call. So if our tone is different today, that's why.

Let me make a few comments about our Q1 performance. I'll then turn it over to our CFO Bill Mudd who will take you through the numbers. I'll talk briefly about the Derby, the situation with horsemen at Calder and Churchill Downs and the balance of the year. We will then be happy to take your questions. I ask since this is about our Q1 financial results today, please address your questions to the business side of Churchill Downs.

We're very pleased with our Q1 performance. Q1 revenue was up 37%. Operating expenses and G&A expenses both increased at slower rates than the rate of revenue. Cash flow provided by operating activities totaled $44.5 million for the quarter. That included $11.5 million of cash from insurance settlements. And that compares to $19.7 million from cash from operating activities in the previous year's first quarter. That number included $0.8 million of insurance settlements. We paid down $18 million in loans ending the quarter at about $50 million in long-term debt. And since the end of the first quarter we have further paid down another $20 million bringing our long-term debt today to $30 million. And we contemplate making another 10 to $15 million payment yet this month. The slots business at the Fair Grounds, our video poker business in New Orleans, and our advanced deposit wagering or ADW business Twin Spires.com accounted for most of the improvements in Q1 results. Racing operations, which consisted of only 57 days of racing in the first quarter, were three days or about 5% below Q1 2007. EBITDA was $9.3 million, including the $17.2 insurance settlement, compared to negative $8.8 millions in 2007's first quarter. That number included $0.8 millions in insurance settlements.

Let me turn this over to Bill now to cover more of the numbers.

Bill Mudd - *Churchill Downs Inc. - CFO, EVP*
Thank you, Bob. Good morning, everyone. I'll be reviewing the information as set forth in the tables of the press release that can be found under the company news section that Julie referred to earlier which is on our Web site, www.churchilldownsincorporated.com. And then as Bob mentioned, I'll turn it back over to him for final comments. As a reminder from our previous call, the discontinued operation section of our financial statements and tables contain primarily of the operations of Hoosier Park, which we sold during the first quarter of 2007, and Hollywood Park, which we sold in the third quarter of 2005. My comments will focus on our performance from continuing operations.

Let's begin by reviewing the segment information which is contained on the schedule that is titled Supplemental Information by Operating Units in the release. Let's start with a net revenues from external customer's line in the table. As a reminder, Churchill Downs racetrack did not conduct live racing during the first quarter. The $800,000 reduction is driven by lower import simulcasting revenues which we believe are attributable to race cancellations at Santa Anita and lower attendance driven by the Louisville smoking ban. Arlington Park, like Churchill Downs, did not have live racing in the first quarter. The slight revenue drop is primarily
the result of lower trade show and food and beverage revenues partly offset by an increase of four post days. Calder conducted two live race days during the first quarter consistent with prior year. Net revenues increased primarily due to the cross simulcasting with Gulfstream Park, which is new versus the first quarter of 2007 as discussed in the last conference call. This allowed our patrons to wager on the Gulfstream Park product as well as other import signals from our facility.

In Louisiana, net revenues jumped $3.4 million over 2007. The reduction of three live race days from 58 days in 2007 to 55 days in 2008 drove lower pari-mutuel revenues that were more than offset by our temporary slots operation. The average net win per unit per day of $250 exceeded our expectations. While we cannot predict future level of play, we are pleased with the performance to date. We continue to work on a permanent facility which we plan to open at the end of the year. The increase in other investments revenue is driven by our ADW business, which is branded as TwinSpires.com and includes a second-quarter purchase of AmericaTAB, and our information services business Bloodstock Research.

Now let's look at the EBITDA by segment. Please note that we modified the method in which we allocate management fees to the operating segments during the fourth quarter of 2007. This change was made as a result of entering the ADW and slots businesses. This impacted the variance in the EBITDA of the operating segments and we've included in a table with the corresponding amounts for each period. Churchill Downs racetrack loss increased by $400,000 versus prior year. Approximately half of this increase is attributable to lower import pari-mutuel revenues discussed earlier while the other half or $199,000 is driven by the change in management fee allocations.

Arlington Park's EBITDA increased by $750,000, driven by an increase in management fees of roughly $1 million, partly offset by additional hosting income for the additional four days. Calder's EBITDA loss increased by $700,000 primarily as a result of non-recurring insurance recoveries of $740,000 recorded during the first quarter of 2007. Excluding insurance, the year-over-year improvement is driven by pari-mutuel revenues by simulcast agreement partly offset by management increase of $144,000.

Louisiana operations EBITDA increased $19.7 million which includes insurance recoveries of $17.2 million for the final payments related to Hurricane Katrina. The remaining improvement is driven by our temporary slots facility and $800,000 less management fees, partially offset by lower pari-mutuel earnings driven by three fewer live race days. The other investments category included our ADW business Twin Spires as well as our investments in HRTV, TrackNet Media and Racing World.

The corporate EBITDA is unfavorable to prior year by $2 million driven by investment in new marketing activities focused on extending the on-track experience to online customers and vice versa. We believe this will increase our on-track and online performance as well as create for sponsorship opportunities like the Red Carpet, Kentucky Derby Party.com, the Lucky U Game, the Road to the Roses fantasy game and the infield Chief Party Officer. The increase in corporate cost also includes an increase related to the equity compensation grants approved during our June 2007 shareholders' meeting. Total EBITDA was $9.3 million for the quarter, which included the $17.2 million insurance settlement, versus an EBITDA loss of $8.8 million in the same period of '07, which included an insurance recovery of $0.8 million. Excluding the insurance recoveries the EBITDA improvement is driven by our ADW and gaming operations.

Now if you would please turn to the tables that is titled Condensed Consolidated Statements and Net Losses for the traditional income statement. We grew total revenues from continuing operation by 37% or roughly $17.9 million for the quarter. Operating expenses grew $15.3 million or 29%. It's important to note this growth rate is lower than the revenue growth rate and is attributable to costs associated with ADW and slots, including the depreciation and amortization related to the acquisition. It includes the increased marketing spin to the new Derby initiatives. Likewise, our SG&A only grew $2.3 million or 24% which is less than our revenue growth. This increase is attributable to our cost associated with our ADW and slots businesses, as well as the equity compensation previously mentioned. Insurance recoveries of $17.2 million represents the final claims related to Hurricane Katrina.

Equity losses in unconsolidated affiliates increased during the year, during the quarter, primarily as a result of the performance in our investments in HRTV and TrackNet Media. Our earnings from continuing operations improved from an $8.4 million loss to a $0.8 million gain driven by the insurance settlement in addition to our performance in ADW business and temporary slots operation. Our fully diluted per shares for the quarter likewise improved by $.69 from a $.63 loss to a $.6 income.

In the last schedule, if you turn your attention to the schedule entitled Condensed Consolidated Balance, I'll briefly review some of the changes. Restricted cash decreased $6.8 million due to the payout of purses at the Fair Grounds during the first quarter consistent with the meet ending in March. Accounts receivable decreased $13.7 million as a result of the collection of simulcast receivables of Churchill Downs and Calder as well as collection of Derby related receivables.

Goodwill increased $7 million as a result of the accrual of earn-out payments related to the acquisition of ATAB and BRIS. This is offset in the create expenses line in the liability section of the balance sheet. Down to the liability section, accounts payable and purses payable decreased during the quarter due to the wind up of the fairgrounds meet from the continued settlement of simulcast related payables from the fall live race meets. Dividends payable were paid out in January. Deferred revenues increased since December as a result of additional first-quarter billings of Kentucky Derby-related and live race memberships at Churchill Downs that will be recognized as revenues in the second, third and fourth quarters. Long-term debt decreased as we've been able to utilize cash from operating activities to pay down our revolving. Overall, we're very pleased with our first-quarter performance. Revenue growth grew 37%. We managed our cost structure, settled the outstanding insurance claim, invested in new marketing initiatives, generated $44.5 million of cash from operations and paid down long-term debt to $50 million. Our balance sheet is very healthy and the company is strong. With that, we'll turn it back over to Bob for some final comments.

Bob Evans - *Churchill Downs Inc. - President, CEO*
Thanks, Bill. Last weekend was the 134th running of the Kentucky Oaks and Kentucky Derby. On nearly every high-level business metric the event was similar to the 2007 version. Friday Oaks was weaker than last year with handle down about 7%. We were up through the first five races. Then really heavy rain started and then wagering on the rest of the race card suffered. Derby handle on Saturday was up about 1% on track and off about 2% in total. The biggest issue on both days was that the Kentucky horsemen would not approve the distribution of our signal to the major ADWs, nor to Calder, except for the three races covered by a separate agreement, the Oaks, the Woodford Reserve and the Derby. This restriction accounted for the overall decline in handle. However, while some final cost and some intertrack settlement numbers aren't in, it appears greater ticket sales, personal seat licenses and other attendance-based revenues, plus sponsorship revenues and media rights fees, also will increase Derby week EBITDA this year by about $3 million over the 2007 level. It's difficult to discuss the entertainment dimensions of the Derby given the tragic events. But we should share with you our progress on several elements of our overall strategy, we have that obligation.

We'll continue to look for ways to use customers on-track experiences such as the Oaks and Derby to drive our online business and to use our online business to drive our on-track performance. Here are three examples. One, our online Kentucky Derby party initiative allowed customers who could not attend the derby to organize their own Derby parties, to invite guests and manage the RSVP process, to utilize recipes and other party tips provided by celebrity chef Bobby Flay, who was our Kentucky Derby party host, to play games, to buy official Derby merchandise, to share photos, videos and text messages with those actually at
the Derby and to sign up with TwinSpires.com accounts so they could wager from their party. We think we have a winner here with Kentucky Derby Party. 6,820 parties were registered. One in at least every state plus Puerto Rico with 46,293 party-goers in in the first year. We hope to build this program to the point where there are more people participating online via Kentucky Derby Party than the 157,770 who attended the Derby on-track at Churchill Downs this year. Two2, our Lucky U game lets people watching the NBC broadcast send a text message with their pick in the Kentucky Derby, and then if chosen at random, win a trip to the 2009 Kentucky Derby. We launched this program in 2007 with 90,000 participants. This year we topped 375,000 participants. Again, linking ontrack and online. And three, last year we launched the Derby Red Carpet Show on NBC as a 30-minute broadcast immediately prior to NBC's 90-minute race telecast. It pulled a 3.2 Nielsen rating. This year we expanded the program to one hour. Based on the preliminary Nielsen
data we have so far, it pulled a 2.0 rating in the first 30 minutes and a 2.8 rating in the final 30 minutes. We're happy with this year's rating given the longer 60-minute timeframe, and since it beat the time slot competitor, the Wachovia PGA golf event on CBS that drew a 1.4 rating and major league baseball on Fox that pulled a 2.1 rating. Oaks and Derby coverage on ESPN totaled 15 hours this year. NBC's Derby coverage increased another 30 minutes to two and a half hours. Viewership of NBC's actual race coverage from 5:45 p.m. to 6:45 p.m. eastern increased 3% this year and was the second highest in the last 17 years.

In the interest of time, I won't cover in detail some of our other initiatives but will mention some of them briefly. Our Derby CPO, or Chief Party Officer, who made numerous TV appearances on ESPN, NBC and local affiliates, our Road to the Roses Fantasy Game which increased its player count this year by 24% to over 18,400 players, and our updated KentuckyDerby.com and KentuckyOaks.com Web sites that generated 135% more unique visitors, over 280,000 on Friday and 82% more unique visitors, over 610,000 on Saturday.

The purpose of all these online initiative is to extend the on track experience to online customers and create more future sponsorship opportunities like Kentucky Derby Party, the Lucky U game, the Red Carpet Show, the Road to the Roses fantasy game, the infield Chief Party Officer and the Kentucky Derby and Kentucky Oaks Web sites. Now established, we expect to generate more sponsorship revenue from these assets in future years. This year's Derby was a classic illustration of how we can grow both the on track and online aspects of our business. On track attendance at this year's Derby was the second-highest ever.

As we just discussed, our online initiatives engaged in total nearly 1 million new potential racing fans and new customers. In addition to creating more sponsorship opportunities, we also seek to monetize online customers via TwinSpires.com. When we acquired the AmericaTAB and Bloodstock Research companies last June, we said we expected to generate $175 million in handle and $43.6 million in revenue in 2008. In Q1 we processed $61.7 million in handle and generated $14.1 million in revenue. If you annualize those Q1 numbers, you'll find we're running well above the handle and revenue projections we made last June. And TwinSpires.com was accretive to earnings in Q1 even if you assign all our HRTV costs to our ADW business. More importantly, we continue to grow our TwinSpires.com franchise. Since the beginning of the year we've added 17,000 new customers and recorded over $24 million in new deposits. Over one half of these new customers are coming from our other Churchill Downs online properties mentioned earlier. Now, wagering is one way to monetize online customers via TwinSpires.com. Another way is to sell them products and services. For example, handicapping data products produced by our Bloodstock Research team in Lexington where Q1 data product sales were $1.8 million and during derby week were over 20% above the level recorded by Bloodstock Research in 2007 prior to our acquisition. Unfortunately, we have not been able to fully monetize the growth in Twin Spires.com customers and deposits since our Florida and Kentucky Horsemen's groups have been unwilling to give us approvals they believe are necessary to send Calder Race course and Churchill Downs signals to the national ADWs including TwinSpires.com.

At issue, is how the takeout that results from wagers made via ADW platforms will be split with Horsemen. The proposed model put forward by horsemen, the so called one-third, one-third, one-third model has one fundamental flaw. It makes our TwinSpires.com business unprofitable. Consequently, we will not accept that model. Rather, we have proposed the TrackNet signal pricing model that has been in effect since we started TwinSpires.com last year. We are convinced the TrackNet model returns more money to the horsemen and tracks that put on the race while providing an adequate return on the capital we've invested and will continue to invest in TwinSpires.com. We think the success of our online Kentucky Oaks and Derby initiatives has already proven the power of the Internet in attracting new fans and customers to thoroughbred racing. And provides a way of monetizing that interest. It is more profitable for horsemen, tracks and ADWs. And we're only getting started here. We believe potential fans and customers will be quite interested in the new features and functions that will be launched in future releases of TwinSpires.com over the balance of this year starting later this month. The Kentucky horsemen's decision to withhold signal rights to TwinSpires.com will affect its performance to some degree.

We would observe TwinSpires.com in effect sells bets. We will direct our marketing and promotional expenditures and efforts to selling bets on those races that TwinSpires.com has access to regardless of whether those races occur at Churchill Downs Incorporated tracks or other tracks. There are 50,000 thoroughbred races in the U.S. each year. This is a hugely oversupplied market in which online betters have already shown their willingness to move their wagers to the best available product. What's perplexing about the Kentucky horsemen's decision is that they have forced handle to go through regional ADW operators like Philly Park or NYRA or others, or through rebate operators, or via the traditional track, offtrack betting simulcasting outlets where they receive one half the share of takeout they would receive if TwinSpires.com processed the same bets.

In addition to the ADW signal dispute we also have another issue with Calder where we've been unable to agree on a method for splitting the revenue from our contemplated slot machine business there. A couple of years ago the Florida horsemen and Magna Entertainment's Gulfstream Park entered into an agreement for splitting the slot revenue at Gulfstream. The Gulfstream Park slots park business has not gone well and we don't want to repeat that outcome. We'll not enter into a slots agreement with Calder that fails to provide us an acceptable return on the significant capital required to construct a gaming facility, or which puts us at a competitive marketing disadvantage visa vi the dogtrack and pari-mutuel operators who also have slots in South Florida and with whom our slot operation at Calder must compete.

We do not expect to move forward with the announcement of our plans or to actually start construction of our slot operation at Calder until the slot agreement and ADW signal pricing matters have been resolved. While we're hopeful we can reach agreement with horsemen in Florida and Kentucky, we must manage our business in a financially prudent manner and be prepared for the possibility that these disputes may continue into next year. We've already reduced purses at Calder by 30% and we expect to have to make further reductions later this week. Similarly, we anticipate that we may have to reduce purses at Churchill Downs effective next week. And in addition to existing and potential purse cuts, we're planning to reduce our operating expense at both tracks and to reduce all nonessential capital spending across the company. We will continue with the construction of the permanent slots facility at the Fair Grounds which is on schedule to open later this year. As the new on track and online Oaks and Derby initiatives discussed earlier show, we are willing to make the substantial investments required in the new ideas necessary to create growth in our industry. But in order to continue to make the level of investments we believe are necessary to create that growth, we belive we must have economic arrangements that are financially sound. And we see no logic in making long term agreements that compromise our collective financial future.

Jeremy, we would be happy to take the first question.

Operator
Okay, sir. Thank you very much. (OPERATOR INSTRUCTIONS.) Please press star followed by 1 to begin. We'll pause for just a moment as questions are compiled. And your first question comes from the line of Ryan Worst with Brean Murray. You may proceed.

Ryan Worst - *Brean Murray - Analyst*
Good morning.

Bob Evans - *Churchill Downs Inc. - President, CEO*
Morning Ryan.

Ryan Worst - *Brean Murray - Analyst*
Just a couple questions. Any insight into how the slots at the Fair Grounds are doing since the meet ended?

Bob Evans - *Churchill Downs Inc. - President, CEO*
Okay. Well, I guess first of all we did see a dip in slots at the Fair Grounds during Jazzfest as parking for our patrons and access to the facility was limited due to the activity on site. Post the live meet we did see a small drop. It's still outperforming where we expected it would be. As we go into this year, there is seasonality related to the slots operation we talked about. You tend to see a small dip during the summer months. So far we've been very pleased with the performance.

Ryan Worst - *Brean Murray - Analyst*
When exactly did the racing meet end?

Bob Evans - *Churchill Downs Inc. - President, CEO*
I believe it was March 23rd. Third week of March. It was March 23rd. I'll have to check.

Ryan Worst - *Brean Murray - Analyst*
Thanks very much. And then you talked about the ADW performance in the first quarter which looked pretty good. But also in the first quarter it seems like you guys have exclusivity on several important racetracks for winter racing like Gulfstream Park and the Fair Grounds. How do you think your content stacks up the remainder of the year? And is an annualized number of the first quarter, is that really realistic?

Bill Mudd - *Churchill Downs Inc. - CFO, EVP*
Well, I'm pretty comfortable with the content lineup going through the balance of the year. There's a couple of race meets such as Oak Tree at Santa Anita, Del Mar and Kemond that we don't have access to. But sort of across all racing, all quarter, we're pretty comfortable with where we are. We're still trying to work out some arrangement where all the ADWs have all the content. I continue to believe that's the right answer for the industry. That puts all the ADWs in the position of trying to be innovative in attracting new customers. I think we'll get the maximum growth that way. At this point we haven't been able to work out those arrangements with those tracks that I mentioned or with TBG who still has exclusive rights to that content. I feel pretty positive about our content position through the balance of the year. As far as annualizing the first quarter numbers, you know, we're not in the business of making projections. I don't think there's any significant change quarter-to-quarter in our content position.

Ryan Worst - *Brean Murray - Analyst*
Okay. And then what do you think is the main impediment to reaching a situation where all providers have all content?

Bill Mudd - *Churchill Downs Inc. - CFO, EVP*
Well, I think it's somewhat of a new day in the sense that Gemstar TV guide, which is TVG's parent company was just sold to Macrovision. I believe it's called Macrovision Solutions now. So maybe we can find a different audience there for discussions on this topic. In the end, the tracks that remain as exclusive tracks can determine the outcome. They're the ones who deals with TVG, ultimately to find what they want to do. It's not up to us. It's up to them. Hopefully if they want to try to remain exclusive, maybe we can work something out with TVG. We'll see.

Ryan Worst - *Brean Murray - Analyst*
When do the contracts expire for like and Del Mar? Are you aware of that?

Bob Evans - *Churchill Downs Inc. - President, CEO*
Do I have them on the top of my head? Maybe someone in the room knows the numbers off the top of their head. Let us get back to you on that. I'd be glad to do it or you can ask them. I don't have the dates in the room here with us.

Ryan Worst - *Brean Murray - Analyst*
Great. Thanks very much.

Bob Evans - *Churchill Downs Inc. - President, CEO*

Thank you.

Operator
And your next question is from the line of George Kelley with Steeple Nicholas.

George Kelley - *Steeple Nicholas - Analyst*
Thanks for taking my call. Just a couple of questions. What is the slot count in New Orleans at the end of the quarter?

Bob Evans - *Churchill Downs Inc. - President, CEO*
245.

George Kelley - *Steeple Nicholas - Analyst*
245? And what do you expect once the permanent facility is open?

Bob Evans - *Churchill Downs Inc. - President, CEO*
600.

Bill Mudd - *Churchill Downs Inc. - CFO, EVP*
We've said 600.

George Kelley - *Steeple Nicholas - Analyst*
Okay. And then second question, could you talk a little bit about the slot legislation in Kentucky and the sort of longer term outlook for that?

Bob Evans - *Churchill Downs Inc. - President, CEO*
There's not a whole lot to say at the moment. The issue is sort of quiet right now. We will find another opportunity to make our case. Whether that's next year during the 2009 legislative session or whether it's during 2010, we haven't made any final decisions on that. It's a function that requires the support of legislators, other community leaders as well as the racetracks in Kentucky. There's sort of nothing to talk about or act on right now.

George Kelley - *Steeple Nicholas - Analyst*
Okay. That's it. Thank you very much.

Bob Evans - *Churchill Downs Inc. - President, CEO*
Thanks, George.

Operator
(OPERATOR INSTRUCTIONS.) And at this time it seems there are no further audio questions.

Bob Evans - *Churchill Downs Inc. - President, CEO*
All right. Well, Jeremy, thank you very much. To those of you that joined us today, again, thanks for your time and interest in our company. We look forward to talking to you in about a quarter or so. Thanks again. Bye.

Operator
We thank you for your participation in today's conference. This does conclude the presentation and you may now disconnect. Have a wonderful day.