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CHDN - Q2 2015 Churchill Downs Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

Operator

Cameron McKnight *Wells Fargo - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Churchill Downs Incorporated Second Quarter Results Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. (Operator Instructions) As a reminder, this conference call is being recorded.

I'd now like to introduce your host for today's conference, Courtney Norris, Director of Corporate Communications. Please go ahead.

Courtney Norris - *Churchill Downs Inc. - Director of Corporate Communications*

[Thank you, Ashley]. Good morning, and welcome to this Churchill Downs Incorporated conference call to review the Company's business results for the second quarter ended June 30, 2015.

The Company's second quarter business result 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 website titled News, located at churchilldownsincorporated.com, as well as in the website's Investor section. Let me also note that a news release was issued advising of the accessibility of this conference call on a listen-only basis via phone and over the Internet.

As we begin, let me express that 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 as 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.

I will now turn the call over to our CEO, Mr. Bill Carstanjen.

Bill Carstanjen - *Churchill Downs Inc. - CEO*

Thanks, Courtney. With me today are several members of our team, including Bill Mudd, our President and Chief Financial Officer; Alan Tse, our General Counsel; and Mike Anderson, our Vice President of Corporate Finance, Treasury and Investor Relations.

I'll make a few general comments about the second quarter and then turn this over to Bill Mudd. After he is finished with his comments, we'll be happy to take your questions.

The Company delivered record net revenues, up 35% over second quarter 2014, and record adjusted EBITDA, up 34% over second quarter of 2014. We also generated first half cash from operating activities of $194 million, up 63% over the prior year. The two most significant catalysts for this growth are our Big Fish Games division and the continued strength and growth of the Kentucky Derby. That said, our TwinSpires and regional casino divisions also made nice contributions in the second quarter and thus the Company is hitting on all cylinders.

I will spend a brief moment on each division. To start, this year's Kentucky Derby set all-time records for attendance, wagering and adjusted EBITDA. The Derby's overnight TV ratings were the best in NBC's 15 years of coverage, and the highest in 23 years. While all of this adds up to a very good year by any measure, we believe we have lots of room for improvement. We hope to continue building on the cultural profile and profitability of the event. The team is already hard at work, planning for next year and implementing changes to improve our results.

We were, of course, thrilled to see a Triple Crown winner with American Pharoah after the 37-year drought. To respond to a question we expect to be asked either on this call or in follow-ups, we think a Triple Crown winner probably doesn't change the long-term economic trajectory of horse racing, but it certainly doesn't hurt either. So far, using industry as a proxy for help, the data shows that wagering across the industry was up 3.5% in the second quarter, compared to the second quarter of 2014. Note that for 2015 year-to-date through the second quarter, the industry is about flat with prior year. Outside of Kentucky Oaks and the Derby, racing remains a challenging business. We'll keep running at the same way we have with a careful eye on cost structure and a rational clear-eye view of the future.

With respect to TwinSpires.com, wagering was up just about 9% over prior year in the second quarter and adjusted EBITDA was up about 19%. Bill Mudd will go into the specifics in his comments. From my perspective, we still have much work to do to maximize this business, and we will certainly look to apply some of the knowledge and capability we have in Big Fish to TwinSpires.

Our regional casino division also demonstrated growth in the second quarter. Generally, I think our performance was affected by steadily improving regional gaming trends, general stability and consistency in our senior leadership team for this division and processes around cost controls and efficiencies. Our team really has done a nice job on the cost controls. We've also been careful to invest in properties where we thought we could maintain consistent and predictable performance over time. And so far this year, our performance has been consistent with our expectations.

To comment on a subject we are likely to be asked about during the question-and-answer segment of today's call, yes, we are aware of last week's announcement regarding Pinnacle Entertainment and the real estate investment trust, GLPI. We follow closely developments in the gaming industry and are always focused on what is best for our shareholders long term.

Beyond that, we are a public company and do not make public statements on such issues.

Finally, a few comments on the Big Fish. It is performing as we hoped it would when we decided to pursue the acquisition. To remind everyone, we closed last December. This is a business built to adapt as the mobile and online games segment continues to evolve. First and foremost, Big Fish is a mobile focused game developer and publisher with its management processes built around cost-effectively creating and marketing games across the spectrum of different game genres. Portfolio approach is backed by industry-leading analytical capabilities to maximize our marketing resources.

Let's talk specifics. With respect to the social casino segment, we reported pretty significant growth in the second quarter, but we are seeing some deceleration of the overall segment's growth rate. I don't want to overstate or understate this, nor provide you with projections of the segment's growth rate going forward. We don't control that, nor rely on it. Instead, I want to comment on what the social casino team is doing to prepare for the coming quarters.

Right now, we are focused on improving the product, particularly around the first-time user experience and the social engagement aspects in order to better retain customers we attract, particularly during the early period after the customer downloads our app. You will see us continue to consistently publish new (inaudible) also introduced new features, including social features around gifting, social status and achievement recognition.

We are also continuing to refine Vegas Party Slots, which is a separate app from Big Fish Casino, designed to appeal to the more game focused, less socially focused social casino player. We like the Vegas Party Slots product, but we still have some work to do to get the features, functionality and the economy to work optimally.

Our interest in Big Fish and our objectives have always been broader than the social casino space. We are pleased to see Gummy Drop continue to grow, even through a noticeable (technical difficulty) that exists across the social game segment over the summer months. We'll keep rolling out new content every couple of weeks and plan to introduce some other features and functionality that we think our customers will like.

The Free-to-Play pipeline is strong and is starting to be studied by many of you who were following when we soft-launched games outside of the United States. We are happy to talk to the extent we can publicly about some of those activities in the Q&A, but suffice it to say that we have a great deal going on and a fairly full pipeline of new games that we're optimistic about. We are looking for the next Gummy Drop, and we're also pushing beyond the casual space with more and more complex, less casual mobile games, which is a market where our development capabilities naturally takes us.

The premium game PC segment, i.e. our traditional personal computer-based prepaid games business, continues to experience secular decline as we expected, as consumer preference shits towards free-to-play products and mobile devices. There haven't been any surprises or changes to how we think about the space. For the Company as a whole, this has been a satisfying quarter and we feel we have much we can build on over the rest of the year and beyond.

Now I'd like to turn the call over to Bill Mudd, our President and CFO, to provide some additional details on the quarter. After that, we will answer any questions you may have. Thank you. Bill?

Bill Mudd - *Churchill Downs Inc. - President & CFO*

Thanks, Bill, and good morning everyone. As you can see in our press release and from Bill's opening remarks, we set a number of second quarter records, including revenues, adjusted EBITDA, year-to-date cash generated from operating activities and Derby week profitability.

Our net earnings declined 4%, primarily as a result of non-tax-deductible expense associated with the re-evaluation of the Big Fish earn-outs and deferred payments. Since Bill covered the highlights of the quarter, I'll point out a few additional details by segment and then open the call for questions.

Let's start with Big Fish Games, the largest contributor to adjusted EBITDA growth this quarter. Big Fish second quarter bookings growth of 40% matched our first quarter growth rate, but varied by segment. Our casino segment grew bookings 31% year-over-year this quarter, driven by 24% increase in average paying users and a 6% increase in average bookings per paying users. While this growth rate is slower than we experienced in the first quarter, the growth is driven by adding new customers and maintaining a high retention of existing ones. We believe the slower industry growth is driven by broader awareness of the social games products available and the fact that the lower-hanging fruit has been picked. Regardless, we are still very pleased (technical difficulty) percent organically growing business that is picking up market share.

For those of you that look at quarter-to-quarter growth rates, be aware that the second quarter is a seasonally slower quarter driven by family vacations, better weather and kids being out of school among a host of other reasons. Our Free-to-Play Casual bookings increased to 36.5 million, driven by the success of our match three game, Gummy Drop! which is continuing to show nice week-to-week growth and is currently averaging more than $300,000 daily in bookings. Our premium bookings declined 22%. This decline was anticipated and is expected to continue as customers shift from personal computers to mobile devices and as their preferences change to free-to-play game genres.

Moving onto our bricks and mortar casinos segment, we had a very good result this quarter with revenue growth of 2% and adjusted EBITDA growth of 7%.Generally, we are continuing to see strength in the middle and upper tiers of our [database], while the lower tiers have stabilized. Our Calder casino revenues were consistent with the prior year, as the slight increase in slot revenues offset the discontinuation of poker operations in July of last year. Our Louisiana video poker business grew revenue 11% this quarter, on share gains that we believe are driven by the introduction of new machines in our properties. Unfortunately, this was partially offset by a 6% decline in revenues at our Fair Grounds property on the implementation of a smoking ban in mid-April.

Our Oxford property grew revenues an impressive 8% this quarter as a result of gaining share in a rising market. June was the fourth consecutive month we set a new monthly net slot revenue record since the property opened in 2012. Needless to say we are very pleased with our team and that acquisition. In general, our casino adjusted EBITDA growth of 7% is attributable to these higher revenues, but also improved cost controls and efficiencies at most of our properties.

Our TwinSpires second quarter revenues increased 6% driven by 17% increase in unique players. Handle for the quarter increased by 8.6% over the prior year to approximately $289 million, outperforming the total industry handle, which increased 3.5% according to figures published by Equibase. We launched our iOS mobile wagering app this quarter, which has shown an impressive growth so far. We have seen strong improvement in acquisition conversion through the app, and we now have the ability to push notifications to customers, notifying them of live race events, [cars] carryover pools and other promotions. Still very early, but we are pleased with the mobile growth since launch. Our TwinSpires adjusted EBITDA increased 19% or $2.6 million from higher revenues and a lower overall excise tax rate.

Our racing segment revenues declined by $4 million or 3% driven by the cessation of racing at Calder and a 22% reduction in live race days at Arlington International, resulting from the depletion of the Horse Racing Equity Trust Fund first money's in the prior year. Partially offsetting these declines was a 7% increase at Churchill Downs racetrack, driven by yet another record-setting Derby week.

Derby week revenue growth was broad-based with increases in wagering, admissions, television rights, sponsorships and other ancillary revenues. Momentum behind the Derby just keeps growing, and we are already working on plan to make additional changes to the 2016 event.

Racing EBITDA improved $7.1 million, driven primarily by the record-breaking Kentucky Derby week, as well as a $1.6 million improvement at Calder. Partially offsetting these improvements is a decline in Arlington on fewer live race days.

Now I'd like to spend a few minutes discussing changes below adjusted EBITDA that affected earnings from continuing operations for the second quarter. The most significant adjustments relate to purchase accounting items associated with the Big Fish Games acquisition. These adjustments totaled $16.4 million in the second quarter.

The first line item, Big Fish Games acquisition charges of $8.2 million, is related to the fair valuing of the earn-out payment and deferred founders' consideration. As reminder, this will continue to be an item included in the adjustment until all the deferred and earn-out payments are complete, which is influenced by the discount rate, the time remaining until the payments are made, and most importantly, driven by the assessment of how much will ultimately will be paid. At the end of the second quarter, we had $338.9 million of the potential $350 million earn-out payments accrued on our balance sheet.

The next item is Big Fish Games' changes in deferred revenue of $8.2 million. There are two parts to this adjustment. The largest part in this adjustment reflects the change in Big Fish Game's deferred revenue, resulting from a business combination accounting rules of $4.6 million. Another reminder, when deferred revenue balances are assumed as part of an acquisition, deferred revenues are adjusted down to fair value. The accounting rules result in a reduction in revenues and EBITDA presented in the consolidated statements of comprehensive income. In the case of Big Fish, deferred revenues were written down by approximately $47 million, which was directly through to EBITDA over the period which the revenues would have been recognized. We anticipate it will take more than a year to cycle through these revenues out of the balance sheet and into the income statement, but the majority will occur in 2015.

The smaller part included in this adjustment is the change in deferred revenue, excluding the impact of purchase accounting, which reflects the actual cash change in deferred revenue from an operational perspective during the quarter totaling $3.6 million.

The final adjustment we will talk about is other charges and recoveries of $0.8 million, which reflects expenses associated with the demolition barns at Calder. We're currently marketing approximately 60 acres of land that was freed up as a result of that demolition.

Now, please take a look at our consolidated statements of cash flows for the quarter. Cash provided from operating activities increased by $75.1 million in the first six months of the year due to the improvement in adjusted EBITDA, dividends from our Miami Valley Gaming joint venture and the $21.3 million in tax refunds. As a reminder, $11.8 million of those tax refunds belong to the prior owners of Big Fish and is shown as an outflow in the financing activities section the cash flow statement.

Total debt ended the quarter just under $614 million, down $156.6 million since year-end.

With that, I'll turn it over to Bill, who will open the call for questions. Bill?

Bill Carstanjen - *Churchill Downs Inc. - CEO*

Thanks, Bill. Ashley, I think we're ready for questions if there any that are out there.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Cameron McKnight, Wells Fargo.

Bill Carstanjen - *Churchill Downs Inc. - CEO*

NA

Cameron McKnight - *Wells Fargo - Analyst*

A questions for Bill Carstanjen first. In your prepared remarks, with respect to the Derby, you mentioned there's lots of room for improvement. Could you elaborate on those comments a little bit and give us some additional color there?

Bill Carstanjen - *Churchill Downs Inc. - CEO*

Sure, and I'll keep my remarks because we can talk about this one for quarter a while. To start, I think that we've learned a lot from the management and it's taught us that there's probably a fair amount of differentiation and experiences that we can offer our customers between the millionaires row section and some of the premium dining areas, all the way up to the management. We think we've learned a lot more about the experiences that we can offer our customers in between those two different price points. But think over time -- over the near term, you'll see us refine our offerings and come up with some new and innovative experiences that we can offer our customers on that front.

Secondly, I think technology continues to really improve our horizons. I think the utilization of online wagering through TwinSpires and other platforms makes it easier for our customers to participate in the Derby, including onsite where, with a crowd of 170,000, there are lots of lines and there are lots of sticky points in the facility. Utilizing technology to reduce those lines and return that time to the customer helps drive our economics. So those are just two areas where I'd say you'll see us make some tangible improvements in the near term.

Cameron McKnight - *Wells Fargo - Analyst*

And then moving onto Big Fish, Gummy Drop! is clearly doing very well. In broad terms, can you talk about the rest of the portfolio and its contributions to what were pretty strong results of this quarter?

Courtney Norris - *Churchill Downs Inc. - Director of Corporate Communications*

Sure. I'd say one way to think about the answer to that question is to look at our segments within Big Fish. We have our Free-to-Play segment, where Gummy is the largest contributor. There is a series of games below that, that don't rise nearly to the materiality that you see with Gummy, but Fairway Blast, Fairway Solitaire, those are all solid contributors.

Within our prepaid segment, there is just a slew of games and slew of offerings within there, none that I'd say that are material enough that we want to dive into too deeply. But the whole idea of the business really is consistent with those results. We have (technical difficulty) approach. We are constantly testing and putting into the pipeline a series of different games, many of which are going to make marginal or modest contributions, and then you'll see over time, hopefully one like Gummy that make more significant ones. So, there is a fairly healthy contribution of lesser games that we never talked about, but really the bigger, larger drivers are the ones that we do talk about.

Cameron McKnight - *Wells Fargo - Analyst*

And then, finally just moving onto the question on margins. I mean, results were clearly very strong with strong sequential growth to the EBITDA inline. How should we think about margins and the flow-through of revenue growth going forward at Big Fish?

Bill Mudd - *Churchill Downs Inc. - President & CFO*

First of all, we don't provide forward-looking guidance. And I think it's hard to answer that question with one paintbrush. I think, if you take a game like Gummy Drop! -- and that's a great case study of how I think about this business. When you launch Gummy Drop!, the first few quarters of introduction, you're going to lose a lot of money because if you're spending -- lets assume you're spending three months of revenue to acquire a customer, you're going to lose money until you get past that three-month period, right? And you get into months four, five and six. So, the second quarter for Gummy obviously was better than it was in the first quarter because you had all those customers that you paid to acquire from the time we introduced it to the end of March that you've got the benefit of the revenues, without those costs associated with acquiring those customers in the second quarter.

So you if you look forward, let's say we launch -- and everybody knows we've got some games out in geographical lock in the countries that we're testing -- if you take a new game coming out like (inaudible) and if we like the spread between the cost to acquire that customer and the long-term value of that customer, we may spend a whole bunch of money acquiring customers in one period, making that product unprofitable and then harvesting those customers in the future where you really get the return on those investments.

So it's really difficult to say that we won't have periods where we will have a lot of expense to launch a new product that we feel strong about, but I can tell you that we're very diligent. That's where the -- the key of this business is the quantitative analytics capability the team have that is second to none in my opinion with respect to how you invest those marketing dollars. Bill, something you want to add to that?

Bill Carstanjen - *Churchill Downs Inc. - CEO*

I would maybe summarize that a little bit by saying that nobody is more sensitive to the power of improving margins than I think Bill Mudd or myself. We grew up focusing on issues like that. We are focusing on metrics like that and we talk about them, focus on them quite a bit, in particular in our regional casino business.

When you talk about Big Fish, you have to be careful and you have to be thoughtful about not losing sight of the bigger picture when you focus on margins. If you look at some of the competitors of Big Fish or other online mobile games, you can find companies out there where you can see they have higher margins. Well, as you get more mature games, they're going to see improvements in margins because you're not investing in marketing at the same level. When you're in a scenario where you think you have games that you can grow and that you can scale and that can contribute long term, then you're going to have to (inaudible) you are going to have to invest in marketing and that's going to impact your margins, and that's the right thing to do to grow this kind of business.

So you have to take a little bit more of a longer-term view of margins, you have to look at it game by game, and you have to understand that quarter-to-quarter, measuring periods for things like margins can jump around a little bit depending on where in the life cycle you are with respect to a game and how significant that game is for your overall portfolio of games.

So, we do look at our margins very, very carefully. We're pretty comfortable with them. And generally, I'd say the older, the more mature the game is, the better margins you're going to see for. But hopefully, this is the right things long term for the business. Hopefully, at the same time, you're seeing improving and maturing margins by a particular game, you're seeing new games come on board where it's worth investing a lot because you think you can grow them.

Bill Mudd - *Churchill Downs Inc. - President & CFO*

And the one other point -- and I don't want to beat this to death, Cameron, but the one other point that I would make is that on the premium games and the free-to-play games, we use third-party developers, which get a share of the commission. Both games tend to have lower margins than, say, our casino games because our casino games are all in-house. We don't pay anybody for those days. We build those ourselves. So the casino segment tends to have higher margins for that reason, but also because we've got 36-month retention patterns. We've got all these customers that we've retained, we don't have to reacquire. So those margins are naturally higher too. There are lots of factors that go into it. So, I don't want to paint it with one brush.

Operator

Adam Trivison, Gabelli & Company.

Adam Trivison - *Gabelli & Company - Analyst*

Can you remind us -- it's looking like you're going to hit the top end of the earn-out. How you plan on financing that?

Bill Mudd - *Churchill Downs Inc. - President & CFO*

Yes, I'd be happy to. You saw that we ended the quarter at $614 million of debt. We have $1 billion of capacity right now. So, of the $350 million, some of that is deferred, particularly to [appealing] the founder of Big Fish. We have the capacity in place today, Adam, to do that. That being said, the markets are very open to us right now. We have lots of opportunities. So we're evaluating them right now. We went out and did a debt offering, maybe putting cash in the books, we're not too interested in that. So we're keeping eye on the debt markets and we'll make the decision as we get close to the earn-out period.

Adam Trivison - *Gabelli & Company - Analyst*

With regard to the sequential slowdown in bookings you saw in the casino segment, could you provide a little more color? Do you think that's all seasonality or were there some underlying deterioration in the metrics?

Bill Carstanjen - *Churchill Downs Inc. - CEO*

It's Carstanjen again. I'm always careful about this because I think it's easy to make up stuff that you think you're seeing, and we try never to run our business doing that. So I'd say that we suspect there might be a little more seasonality. We think we might be seeing a little more seasonality this summer than normal. The weather was nice. There's some other factors. But we don't know that for sure. But certainly seasonality is a phenomenon that's recognized as a part of the rhythm of the social casino segment and broader, the game segment. So that's a factor. But, I think also you just have to expect over time, you'll see deceleration in growth. The social casino space isn't going to grow forever at the rate it has been. So, from the very beginning, you have to be cognizant and expect that. How much of all that and how that [stew gets] made and how do all those pieces put together, we don't really know for sure since it's something that we don't control. What we focus on is how do we make our product better so that we can still grow organically and we can take share. So we're not only as good as the market, but we're better than the market because we're outperforming our peers. That's really the culture and the mindset that we bring in all our businesses, and that's why I was covering in my comment, some of the focal point for the Big Fish social casino division, what they're doing to make their product better so it's a more competitive product and stands up to whatever the trends are that we see. We may find next quarter, it bounces back again. I wouldn't be surprised. But we don't want to predict something like that and we don't want to take it for granted. We want to make sure that we're performing best in class.

Bill Mudd - *Churchill Downs Inc. - President & CFO*

And Adam, the way we look at it is, we're going to look at it year-over-year, in the same quarter, rather than quarter-to-quarter because there is noise. It's a relatively new industry, so you don't have 30 years of data to show the seasonal effect of some of these products. But we have 24% more paying users than we had in second quarter of last year, and they're spending on average 6% more. So those are the numbers we focus on and we look at those numbers relative to our competition, we feel good about though.

Adam Trivison - *Gabelli & Company - Analyst*

Then, one last thing. With regards to the growth you saw from Derby week, how much of that was related to the NBC deal, and I think there is some more step-up in that next year and maybe the year after? Can you detail that?

Bill Mudd - *Churchill Downs Inc. - President & CFO*

We don't release those numbers. NBC doesn't want us to talk about what our contract is with them. But there was a portion -- it was a minor portion of the $6 million in growth from the NBC contract. There is another step-up next year, and then we're kind of flat for a couple years and there's another step up later. That's about all I can say on that point.

Operator

(Operator Instructions) I'm not showing any further questions. I'd like to turn the call back over to management for any further remarks.

Bill Carstanjen - *Churchill Downs Inc. - CEO*

It looks like we're all said for today. I want to thank all of you for your interest in our company and for those of you that are investors, your investment in our company. We appreciate it. We hope to keep delivering for you. Thanks very much.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a wonderful day.