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CHDN - Q3 2014 Churchill Downs Inc Earnings Call

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CONFERENCE CALL PARTICIPANTS

Operator

Cameron McKnight *Wells Fargo - Analyst*

Steve Altebrando *Sidoti & Company - Analyst*

Robert Shore *Union Gaming - Analyst*

PRESENTATION

Operator

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

I would now like to introduce your host for today's conference Mrs. Courtney Norris, Director of Corporate Communications. Ma'am, you may begin.

Courtney Yopp Norris - *Churchill Downs Incorporated - Director of Corporate Communications*

Thank you, Trea. Good morning, and welcome to this Churchill Downs Incorporated conference call to review the company's business results for the third quarter ended September 30, 2014. The Company's third quarter business 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 website titled News located at churchilldownsincorporated.com, as well as on the website's Investors 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 a 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.

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

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

Thanks, Courtney. With me today are several members of our team including Bill Mudd, Chief Financial Officer and President; Alan Tse, our General Counsel; Mike Anderson, our Vice President of Corporate Finance, Treasury and Investor Relations; Scott Graff, our Vice President, Corporate Controller and Bob Evans, the Chairman of our Board of Directors.

I'll make a few general comments about the third quarter and then turn this over to our President and Chief Financial Officer Bill Mudd. After he has finished his comments, we'll be happy to take your questions.

There were five developments in the third quarter that are worth recapping. First, we made a few significant organizational changes during the quarter, including Bill Mudd becoming President of the Company in addition to retaining his responsibility as Chief Financial Officer. At the same time, I became CEO after previously serving as President and COO for a number of years, and Bob Evans stepped down from the CEO role, but remains Chairman of Board of Directors very much an active daily force in the Company. These are important changes and certainly meaningful ones on a personal level for Bill Mudd and myself.

That said, we will continue forward with the same approach, same discipline and the same commitment to driving growth and shareholder value. We also will continue to focus our attention on the careful allocation of capital and on cost management as we've done over the last few years.

Second development worth recapping, we purchased 691,000 shares of common stock for $61.6 million in a privately negotiated transaction. While this buyback technically happened on the very last day of the second quarter, this is the first quarter where you see the results in our earnings per share.

Next, we completed a transaction with the Stronach Group in July, which we leased Calder Casino's horse racing operations to them. We maintain full control of the casino operation, which is the attractive economic activity on the site of satisfying the state legal requirement that we conducted racing in order to maintain (inaudible).

As Bill Mudd will explain this reduced revenues for the quarter and created large one-time costs accounted for a significant portion of decline in net earnings in the operations. But this transaction is a clear positive at the EBITDA line going forward. So we're very pleased with having them.

Fourth development, we completed our application filings and testimony with respect to our New York State Capital Region casino bid. We do not know when the New York Gaming Facility Siting Board submit its recommendations for this franchise. So we are hopeful that it will be this quarter. We worked hard on this one and we'd like our chances.

Finally, we announced the signing this week with a transaction to acquire 25% of Saratoga Harness Racing Inc., and our entry into a management agreement to operate Saratoga Casino and Raceway in Saratoga Springs, New York and the Saratoga Casino Black Hawk, Black Hawk, Colorado. This transaction is a nice addition to our gaming operations, further cements our bid application in the Capital Region, fits within our strategy of having gaming interests in states who would like to participate in Internet gaming in the event such states that authorizes. These developments stand for the proposition of the Company will continue to look for more opportunities to put our balance sheet to work and grow and we will return capital to our shareholders when we see that it makes sense to do so.

With respect to our three business segments, I would like to briefly highlight a few things. For our regional gaming business, the general trends in the economy and in our specific markets remain soft, and thus our focus is firmly on controlling cost and ensuring efficient marketing spend. We'll continue to focus on what we have the most control over, that is operating our assets efficiently when it looks like the top line may not grow.

With respect to our online segment, we had a real headwind in 2014 because of the loss in late 2013 of the Texas online wagering (Technical Difficulty) and because of new taxes imposed on New York and Pennsylvania (Technical Difficulty) activity. Those are three very important states where you can see the impact of our financials. Comps get easier next year and we are pleased that this segment continues to show organic (Technical Difficulty) like the gaming segment, we will be keeping a close eye on the cost structure and on any further potential changes to the taxation or regulatory environments we operate in. Personally, we have nothing [to do] with respect to that at this time.

Turning to the racing segment. The Kentucky Derby follows and indeed makes its own trends, those are very strong. Racing outside of the Kentucky Derby, however, is a very challenge for our Company and the industry as a whole. We don't see anything on the horizon that suggest this will to consequently and focused on our cost structure, as well as creative ways like our (inaudible) improve our performance.

Finally, since the quarter was recently ended, we've done a couple of those developments (Technical Difficulty). First, we announced another increase in our Company dividend from $0.87 per share to $1, 15% increase. We have now doubled the dividend since 2011, which reflects our commitment to return cash to our shareholders when the circumstances are right. Secondly, we announced yesterday a $4.2 million capital project for our flagship Churchill Downs Race Track, which we think will bring even more energy to our facility (Technical Difficulty) as well as bring a further improvement for (Technical Difficulty). This project will be completed in time for next year's Kentucky Derby, which is worth noting is now [184] days away. And as another indication of our (Technical Difficulty).

Finally, Forbes just named us to list of Forbes 100 Best Small Companies in America (Technical Difficulty). While the Kentucky Derby consistently makes Forbes list of Most Valuable Event Brands in Sports, we have never made the best small companies list. We were flattered to make the list (Technical Difficulty).

Now, I would like to turn this over to Bill Mudd to provide some additional details on the quarter, after that, we'll answer any questions. Thank you. Bill?

Bill Mudd - *Churchill Downs Incorporated - President & CFO*

Thanks, Bill. Good morning, everyone. As Bill mentioned in our press release, we are pleased with our third quarter results, which met our internal projections. I'll take you through our segment revenue and adjusted EBITDA results first, as that will help frame our total Company revenue and earnings.

Our racing operation results were in line with our expectations with revenues down 19% or $9.6 million. The good news is that the revenue loss resulted in only a $0.3 million decline in adjusted EBITDA. As expected, the leasing of racing operations at Calder is the primary driver of the revenue decline. Please note that we will continue to see these revenue declines related to these events through June of 2015.

You will also notice below adjusted EBITDA $2.3 million of other charges this quarter. These one-time charges are related to severance and other costs associated with exiting racing operations at Calder. In addition to these other charges, our depreciation and amortization line includes $1.3 million of accelerated depreciation related to barns that we will no longer be utilizing starting January of next year. We will incur an additional $2.3 million of accelerated depreciation in the fourth quarter. Taking the book value of these assets to zero as we decide the best use of this 60-acre (Technical Difficulty). While our third quarter earnings and to a lesser extent our fourth quarter earnings are negatively affected by these shutdown costs, we believe this transaction as a positive element for long-term financial performances.

Earnings should continue to improve over the next few months as we close our barn areas at the end of December 2014, consolidate buildings, cancel service contracts on elevators and escalators and like, and reduce insurance and taxes on certain assets.

Our racing adjusted EBITDA improvements from Calder lease income offset by lower earnings at our other properties on lower pari-mutuel revenues, which were experienced industry-wide in the third quarter.

Our gaming operations revenues increased slightly to $81.8 million, [gains] over the previous year were driven by 16 additional days of operation at Oxford that we acquired in July of 2013. On a comparable days basis, Oxford increased revenues about 1% year-over-year. Harlow's is the only other gaming property that also organically grew revenues in the period, also up 1%. Partially offsetting these gains was a $1.1 million decline at our Calder Casino. Approximately $700,000 of this loss is due to the exit of poker operations at the end of June. While poker was not a profitable product for us, it did provide another reason to play slots at our facility. We have the ability to restart poker operations beginning in July of 2015, if we determine that makes economic sense to re-enter that market.

Our other gaming properties experienced declines of 3% to 5% and we're line with what other operators' experienced in those markets. From a customer perspective, we continue to see a similar pattern of softness at the lower tiers of our database with more players making fewer trips at a lower win per trip.

Gaming adjusted EBITDA increased $4.4 million. Our share of operating income at Miami Valley Gaming, operating income is after depreciation and amortization costs added $2.6 million in the quarter and a full quarter of Oxford operations added $1.3 million. Additionally, Harlow's adjusted EBITDA improved $0.7 million from cost reductions and an improvement in table games volume and (inaudible).

Our online business performed very well despite (Technical Difficulty) decline in revenues. There were two big drivers this year-over-year decrease. First, total wagering on U.S. thoroughbred racing declined by 4.2% (Technical Difficulty). The bulk of the decline came in September with the industry down 10.6%, on a 7% decline in the number of races. We certainly hope September was an anomaly since July and August combined was only down 1.8%.

The second driver is the continued loss of Texas resident wagering, but it was not surprising. As we discussed in our 10-Q, September 25, the Fifth Circuit U.S. District Court ruled in favor of the Texas Racing Commission in an unpublished opinion stating that we failed to approve the law (inaudible) against out-of-state providers. We think this is facially discriminatory, easy to prove and we are evaluating our options on how to proceed.

Excluding Texas resident wagering for 2013, online wagering handle increased 3% year-over-year, compared to an industry decline of 4.2%, meaning TwinSpires outpaced the industry growth by 7.2 percentage points. This growth rate differential is consistent with historical trends.

Online business adjusted EBITDA declined by $1.9 million, primarily due to the loss of Texas resident wagering, which cost [$1.7 million]. In addition, higher taxes and regulatory costs in New York and Pennsylvania added $0.7 million of expense. These losses were partly offset by organic growth and fewer losses in HRTV.

The impact of Texas resident wagering is behind us as we start taking wagers on September 25 of last year. We also settled our lawsuit with the State of Pennsylvania challenging the 10% tax on out-of-state ADW operators and we'll now be subject to same rate as in-state operators.

We've recognized the lowest in-state rate in our third quarter 2014 reported results and filed a refund petition for the period from October 1st of last year through June 30 of 2014 totaling $1.9 million. We will recognize this refund in our income statement when that cash is received, but the lower rate will improve our results over the next nine months. The only headwind that remains is one more quarter of New York ADW taxes, which went into effect on January 1st of this year.

Earlier this month, we decided to cease the operations of Luckity, our online real-money Bingo product. While we were able to attract and retain customers the cost to acquire them compared to the lifetime value made the product economically unviable. As a result of this decision, we will report a non-cash impairment charge of gaming assets associated with this product in the fourth quarter totaling $3.2 million and eliminate all the spending on this product going forward.

Our other investments adjusted EBITDA declined $1.7 million this quarter, primarily related to investments to grow the Company in the future. We spent $1 million on the continued development of our iGaming platform, a $900,000 increase over the previous year. We also spent $0.4 million on the application process to win the bid for the New York Capital View gaming license. We believe our Capital View project has a great chance of winning and hope to learn the results before year-end. Finally, our United Tote business adjusted EBITDA declined $0.4 million on lower service and equipment sales.

In total, our third quarter total net revenues declined to $173.7 million on the lease of Calder racing operations and the loss of Texas online resident wagering.

Adjusted EBITDA set a new third quarter record at $32.2 million slightly better than last year's record third quarter. Net earnings from continuing operations for the quarter were $0.20 per share, down from $0.52 prior year. The decline was driven by a number of Calder lease related items discussed below adjusted EBITDA, plus the recognition of non-recurring Illinois Horse Racing Equity Trust Fund proceeds in the prior year.

With that, I'll turn it over to Bill Carstanjen who will take any questions you may have. Bill?

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

Thanks Bill. Trea, I think we're ready to open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Cameron McKnight, Wells Fargo.

Cameron McKnight - *Wells Fargo - Analyst*

Good morning. Thanks very much. A question on leverage, you got one asset that's we think no one else in regional gaming has which is low leverage and relatively free balance sheet. How are you thinking about the balance sheet and uses of capital and capital work sense going forward?

Bill Mudd - *Churchill Downs Incorporated - President & CFO*

Good morning, Cameron. The way that we think about it, we don't wake up every morning saying that we have an ideal leverage in mind. We look at opportunities and obviously we have the ability to take some swings and obviously there are a lot of factors that go into place when you think about leverage of the Company. But when we think about it, ultimately it depends on where you're going to use the money on and how long the tender is on the debt, when that debt will be due.

The last thing we want to do is find ourselves in a position where we're heavily levered and we'd have to refinance in a market -- in a debt market like we saw in 2008 and 2009.

So beyond that, I really can't make much more comment, I mean, you've seen that we've purchased shares back when it made sense, you see that we continued to raise the dividend and doubled the dividend since 2011 and that's how the management team things we do acquisitions makes sense and we pass on acquisitions that don't make sense. So that's kind of how we think about it.

Cameron McKnight - *Wells Fargo - Analyst*

Okay, great. Thanks. And then the new suites that you've announced next year at Churchill Downs, how should we think about the potential impact there?

Bill Mudd - *Churchill Downs Incorporated - President & CFO*

Yeah. The suites are going to create a whole new dynamic for our owners. I think it's going to create a much better television product because it's going to have all the connections of the owners and a nice easy to view format for television, as well as for patrons that come to the race track. In terms of the profitability on that, I think there is a multiple year view of how we're going to get that return. But overall, I would say that I think you're going to -- we think about the Derby in five year increments, not one year increments. But it's going to be a positive for us.

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

I would add to that anytime we consider our capital project for Churchill Downs Racetrack, of course, have to think of and focus on the customer improvement and the customer experience and the aesthetics of what we're doing, but we don't do these things unless they are also going to generate a positive economic return.

Cameron McKnight - *Wells Fargo - Analyst*

Okay, great. Thanks very much.

Operator

(Operator Instructions) Steve Altebrando, Sidoti & Company.

Steve Altebrando - *Sidoti & Company - Analyst*

Hi, good morning. I believe there is a $1 million of expenses associated with the online casino platform. Just wondering how optimistic you are at this point on generating an ROI? And then are those costs kind of -- are they one-time in nature in terms of building a platform or do they really reflect more operating expenses associated with it?

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

That's a good question, Steve. Thanks. In order to be ready for online gaming as it's go state by state and to us, the way the environment looks for the near-term and the mid-term is, it looks like a state by state series of decisions. In order to be ready for that, you have to start well in advance. So we'll watch the legislative sessions across a number of states next year to see where the issue is hiding and where there might be activity. But we can't control when the states -- if and when the states are actually have some form of online real-money wagering. However, to be ready for it, we needed to start when we did, so we put forth the opportunity to build a world-class platform to compete effectively as the laws in the country do change.

The cost right now being incurred are largely to produce the platform, there are investments necessary to produce the platform that takes a period of time to get that ready and then those people might get redeployed in other projects and other activities but the platform itself will be complete.

Steve Altebrando - *Sidoti & Company - Analyst*

Okay. And then in terms of Calder and the seasonality of the race track, I'm referring to. I believe historically first half of the year was weakest and second half was strongest. So, is it reasonable to expect that why you're probably getting impacted from an EBITDA basis in the second half that the reverse should be the case in first half '15?

Bill Mudd - *Churchill Downs Incorporated - President & CFO*

I'm not sure I completely understand your questions, let me maybe take a different tact at how to think about this. Starting in July of last year, Steve, I think you're bearing the burden of having a lot of historical knowledge. Starting in July of last year we ran head-to-head against Gulfstream Park and ran basically year around from July of last year and through June of this year.

So I think all these quarters were relatively consistent. I think the third quarter of this year we had obviously some time where we had employees in the books where we were paying them and we weren't really utilizing them because we had notification periods. Certainly had people hanging around to get the operations closed down and transferred. Clearly experienced some one-time severance costs and (inaudible) incur some accelerated write-down of assets that will no longer be utilizing.

And then part of our deal with The Stronach Group, there is other pieces to the deal that take effect later. So, for example, the barns, we're keeping open on the back side which has significant amount of expense through the end of this year, that goes all the way January 1st and there is other parts of the agreement with The Stronach Group that don't take effect until January of next year. So you'll see more of this bleed in over time of the agreement with Stronach Group piece, that answers your question.

Steve Altebrando - *Sidoti & Company - Analyst*

Okay. And then just lastly, the sequential decline in EBITDA in Miami Valley, it looks like the revenue trends based on online the state gaming trends was not that much of a sequential change in revenue, but there was a sequential drop in EBITDA. So I was just wondering if there is anything one-time in the quarter that impact Miami Valley?

Bill Mudd - *Churchill Downs Incorporated - President & CFO*

Yeah, there are a couple of one-time items; we made a payment to the county for -- as part of the agreement, when we got the license that kind of wrapped up. You did see that September revenues were down as with the open of Dayton. We declined -- the whole market declines, when you look at the delta between how much we declined versus what they declined. I think the impact from that asset was less than we expected. It's still early. So far we feel very optimistic and certainly within range and better than we had expected, when they would open, but yes, there were a couple of one-time items. And so anyway, that's --.

Steve Altebrando - *Sidoti & Company - Analyst*

Okay. Thank you. That's helpful.

Operator

Robert Shore, Union Gaming.

Robert Shore - *Union Gaming - Analyst*

Hey, guys. I had a question on Illinois. With the Governor's Race coming up, I mean, how could a new Governor kind of change the political dynamics in that market? And kind of -- what are your long-term thoughts on gaming expansion in Illinois, and if it does come to fruition [Arlington Park] uses?

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

Robert, it's Bill C, I'll take that one. So, the Governor's Race is a fairly tightly contested race. The election is next week or the week thereafter it's coming right up. Governor Quinn, of course, historically was not supportive of further expansion of gaming in the state, but over the last year, the discussions have become much more focused with him and we felt better and better about it as we -- and the industry as a whole addressed some of the concerns he was raising.

With respect to a change in the Governorship, we feel the issue of expanded gaming in Illinois, it's just a complex issue, I mean, both candidates have made comments to suggest they are very open to it, but they're tied up other issues, community support, also there is always the issue of City of Chicago and their needs and their request for gaming bill. So I'd say, if you look at Illinois and you contrast it with say, Kentucky, Illinois is a much more complex jurisdiction where the issue of expanded gaming just is tied up with other issues that are important and going on in the state at any point in time.

So I'd say that regardless of the election results for -- come about from next week's election will be locked and loaded to work this issue going forward in the next legislative session and there is cause for optimism and then there is cause for caution as we think through all the other issues that will come into play.

Longer term, we have a valuable asset with our Arlington Park continue to work it for expanded gaming but we will constantly look to serve the best interest of the Company long-term. So that's our responsibility as a public company. So long-term, we'll evaluate our options as we have to, and as they come about. We're very open minded long-term. Short-term, we'll continue to push really hard to expand gaming.

Robert Shore - *Union Gaming - Analyst*

Got you. Thank you. That's very helpful.

Operator

Thank you. And at this time, I'm showing no further participants in the queue. I would like to turn the call back over to management for any closing remarks.

Bill Carstanjen - *Churchill Downs Incorporated - CEO*

Thanks everyone. I don't think we have any further closing remarks. So thanks for your time and we'll talk to next time.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This concludes the program. You may now disconnect. Everyone have a great day.
