



Race Track Industry Program

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KEYNOTE LUNCHEON

**LORNE WEIL
CEO AND CHAIRMAN
SCIENTIFIC GAMES CORPORATION**

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MR. LORNE WEIL: Can you hear me? Thank you very much. I want to just begin by stressing my appreciation for having me as the speaker today. I'm delighted to be here and I'm looking forward to it.

My assignment is to try and say something new or at least interesting about the subject of racing wagering — racing and gaming, and I think under the best of circumstances that's going to be a tough job to do because of the fact that you people here have probably heard a thousand speakers already on the topic.

And the fact of the matter is I'm not honestly sure that I know enough about either racing or gaming to really qualify for this assignment. But fortunately or unfortunately, depending upon your point of view, I think I do know enough just to be dangerous. And so I'm going to give it my best shot.

My former wife used to say, not entirely affectionately but I think probably not entirely inaccurately, that I was an individual who was frequently wrong but never in doubt.

(Laughter)

And so in the spirit of full disclosure I would ask that you keep that in mind as I go through some of this material. When I started coming to these conferences many, many years ago it was a racing conference. And over the years it gradually became mainly a racing conference with a little gaming tossed in; and now judging by the agenda, it seems to be essentially a gaming conference with a little racing thrown in.

And so this seems to suggest that the racing industry has pretty much embraced and hitched its rope to the hopefully rising star of the racino. Now, I happen to love racinos, I think they're great. It's a great concept, it has terrific success obviously in practice. Many of my best friends own racinos. Much more importantly, many of my best customers own racinos. So of course I love the industry.

But having said that, I must say that I myself do not believe that the racino nevertheless is the salvation of the racing industry as apparently a number of other people do. And for better or for worse, I have some fairly decent company in that point of view.

I wasn't able to come to the conference last year for family reasons but I did have an opportunity to read the speech that was given by Tom Meeker, an individual who is at least as uncertain as I am, and he expressed the same view.

And he basically cited the change in the economics in the racino world over the last few years. And I would wholeheartedly agree with that. A few months ago during the Jewish High Holidays the rabbi at our temple told a cute and I think pretty relevant story.

It seems that back in the late 19th century and early 20th century the Jews that lived in Eastern Europe were — there were concerns about the welfare of one another. And there was this one old guy who was very down on his luck, just couldn't make ends meet.

So the elders in the village got together with him and they said, "Sir, your job is to stand up on top of that hill and watch over the side. And when you see the Messiah your job is to jump up and down and wave your arms and stamp your feet and scream at the top of your lungs when you see the Messiah coming."

And they said, "You know it doesn't pay much, but it's steady work."

(Chuckles)

And so I think the racing industry — I'm concerned that what we are is a steady job. And it don't pay much while we wait for the Messiah that may never come.

The idea of the racino was that it would solve an economic problem that both the casino business and the racing business have, which is a problem with utilization of assets.

The racing industry, of course, thinks that the problem is unique to itself, and it looks longingly and enviously upon the casino business trying to understand the lessons of its success.

But I think to illustrate a situation of perhaps being careful what you wish for because it might come true: Several months ago I had an opportunity to attend an investment congress in Las Vegas to speak about a subject I actually do know

something about, which is our Scientific Games. And after I finished my presentation I hung around for a few days and I listened to a number of speeches, many of which had to do with the resort/casino business, and this is what I learned.

Basically, investment in that business comes in multiples of billions. First was a billion for the Mirage and then it was two billion for Venetian and then it was three billion for the Wynn Hotel and now I guess somebody in Las Vegas is considering a \$4 billion project.

It seems that for every billion you invest you can expect to get a hundred million dollars in profit, and then it seems you have to invest about \$30 million of that every year into the maintenance, because apparently after that they have to tear the rooms apart, or something; and then if you borrow on the building you will pay \$60 or \$70 million in interest.

And so when you're all done, by the only measure that really matters, which is how much cash is in the cigar boxes at the end of the year, this is actually a great deal profitable. When I was a kid growing up in Toronto, we used to have a running gag in our family.

My grandfather was a dedicated horseplayer. This was at the old Woodbine downtown before it moved out by the airport, where I wasted most of my college time.

And on a Saturday or Sunday I'd say, "Grandpa, what are you doing today?" And he'd say, "I'm going to the racetrack."

And he'd pause and say, "I hope I break even, I need the money."

(Laughter)

So I think how to invest a billion dollars to break even is not a lesson that the racing industry at this point in its evolution needs to have from the casino or anybody else. And to paraphrase what they say on TV, this is one thing that has happened in Vegas that could stay in Vegas.

But in a way luckily for this industry the racino came along, and that was a way, as I said before, to better utilize the assets. But as Tom Meeker correctly pointed out in his talk last year, they are perhaps the third part of the equation, and of course that's the state governments.

I think most of you know that the overwhelming majority of the racinos in the United States are operated under certificate under the state and financial waters, and so I think it's important for these, at least useful to take a second and look at the lottery industry business model, because I think that would provide some insight into the issue that Tom raised in his speech last year.

The lottery business in North America is about \$50 billion a year in sales, handle we call it in the racing business; about 55 percent of that is paid out in prizes, 45 percent therefore is retained by the lottery, that's obviously a terrific takeout.

About 15 percent goes to overhead expenses, so at the bottom line you have a profit of about 30 percent of revenue, or in this case to the industry about \$15 billion a year. This is obviously a sensational business model. It is a considerably better business model than the casino business model. It's even a better business model than the tote business model, which is something that my friend, Chuck Champion, judging by the reaction to the stock market, is learning the hard way sooner than he thought.

So this is obviously a business model that the lotteries and their overseers on the lottery commissions and state treasurer's office are not anxious to really push. And I think what people in the racing and gaming business view or bemoan as the, quote, "racino tax," that is really in point of fact appropriately and understandably what the lotteries and state financial people view as a normal part of their business model.

The question is: Where's all this money going in the lottery business? Years ago when the industry first came into being it went into a black hole that was known as the "General Fund." The public didn't like this very much and so over time this has changed.

Now pretty much all the lottery proceeds are specifically earmarked for special social causes; the overloading of general education; but it also goes to things like senior citizens, prescription drug programs, ecology and things of that sort. And so at this point it really becomes a question of numbers.

And from the political point of view, take New York for example. I've heard it estimated that directly or indirectly there are about 50,000 people who are employed in the racing industry in New York; and I suppose if you include the tracks, OTBs, tack, agribusiness, veterinarian and so forth, that might be right.

And so this makes for a pretty compelling political argument, again as Tom points out, from the point of view of economic development.

But then I need to remind you that in New York State there are approximately four million school-age children. And allowing for sibling and deadbeat dads and whatever, I would guess that these four million school-age children probably correspond to about six million parents.

And so what it comes down to is this: The six million parents who care deeply about education, versus less than one percent of that number or about 50,000 people who, in varying degrees, are passionate about horse racing, and I think it's just that simple.

And speaking of kids, I myself, back in New York where I live, have a 3-year-old little girl and a 4-month-old little boy, and they would appreciate that there'll be nobody here who will shoot the messenger.

I'm going to now switch to a different subject, another one actually has happened that's near and dear to the heart of Mr. Meeker, and that is technology. And I would certainly agree wholeheartedly with Tom that all of technology is — a solid technology foundation is certainly necessary for the future of the racing industry.

Those of you who know me know that my entire career in one way or another, going back to when I worked for General Instrument 30 years ago, was involved with technology.

At Scientific Games we employ upwards of 300 degreed engineers and programmers and scientists, we have an annual research and development budget in excess of \$40 million, an increasing proportion of which I'm pleased to say we're allocating to the racing business.

At the moment we have access in the other building all by itself, almost caused me to issue profit warnings to Wall Street when I saw the budget for it, and we recently hired as our new corporate chief technology officer a guy by the name of Steve Beason, who for many years was with Hong Kong Jockey Club, certainly one of the most technologically progressive racing organizations in the world.

So technology is very, very important to us, and we are very, very committed to doing everything we can to support the development of technology.

But having said that, again at the risk of having somebody shoot the messenger, I do not think that technology is any more the savior of the racing industry than I think the racino is the savior of the racing industry.

Certainly it is a necessary condition, but it's not even remotely a sufficient — or put it another way — technology is really at best an enabler of growth, but in and of itself is by no means a driver of growth. And it is of course the driver of growth that this industry is concerned about.

I can illustrate this point easily by pointing to the billions and billions and billions of dollars that were wasted in the late '90s on technology that was technically enabling but frankly commercially idiotic, leading up to the burst of the so-called tech bubble, but that would be shooting fish in the barrel, so I'll try and illustrate the point by showing something that's a little bit closer to home.

In last 10 years there has been approximately \$2 billion spent to upgrade the technology of an industry called the online lottery, or segment of the lottery world called online lottery.

Probably 80 percent of this investment was made by one company alone, the company called G-Tech; and the balance was made by a couple of competitors of theirs, including ourselves.

Parenthetically, I should say that when a lottery person uses the term, online lottery, it doesn't refer to the Internet, it refers to the traditional network of thousands of retail terminals scattered around the state communicating to a central computer system over some kind of a dedicated communications network that is mostly satellite, and so this sounds quite a bit like what we do in the racing business, and indeed it is.

Speaking of the racing business, I should mention that I have had a chance to study the racing consorts through RFP; I think it's extremely provocative. I think it's well done, well organized, very comprehensive, and I take my hat off to the people who put it together and to the companies that financed it, because I think they have done an excellent service to the industry.

But having said that, I think that even if every single requirement of the racing consortium RFP were to be implemented on behalf of every single racetrack in this country, and I would consider that a very unlikely outcome, I don't imagine that even 10 percent, maybe not even five percent of \$2 billion that was spent on the lottery business will wind up being spent to upgrade the technology in racing.

So \$2 billion is an awful lot of money, and the question is — or the assumption is that if the lottery industry can spend that kind of money obviously it must have generated a lot of growth.

The fact of the matter it did not, as you can see looking at this particular slide. Now, the fact ironically — I think I'm probably correct in saying that over the last 10 years the thoroughbred racing industry has probably had higher average annual growth rate than has the online lottery business.

So what we have in the lottery business or what they have in the lottery business right now are systems that are capable of processing probably a thousand times as many transactions a second as they had 10 years ago.

But guess what? They're not selling now one more thing. And the underlying reason for that is something I can summarize in three words: Content, Content and Content.

The lottery business is selling the same products essentially as it was selling 25 years ago when I was at General Instrument; where, as it happens, all of the technology that gave birth to the online lottery was actually developed. And if you continue to sell the same products for 25 years without any upgrading, then you will certainly never attract any new customers.

If you don't attract any new customers you're never going to grow, because there's always a limit to what you can extract from the current customer; even though I

always believe in the adage that the easiest person to sell something to is somebody you sold something to before.

If you can't bring in new players in any business you can't grow. And if you don't change the product, you don't change the content, then no matter what you do you won't bring along any more customers.

Now let's contrast that with the other segment in the lottery business called "Instant Tickets." And here you can see an entirely different picture. This is a business that's not only growing, it is actually growing at an accelerated rate; and this is probably the fastest growing segment of the gaming business in the United States. To be sure, a lot of technology is involved in the design and the programming and the production and security involved with instant tickets, but what's really driven this growth is content.

And let me give you just one example. A few years ago we decided at Scientific Games to develop a portfolio of theme lottery games that used proprietary licensed brands. This is a picture of some of the products in that portfolio. We are, I think, the only company in the world associated with gaming that has a license from the NBA. We have a license from Wheel of Fortune, Jeopardy, Monopoly; we have the two hottest brands in the poker business right now, World Series of Poker and — World Poker Tour and World Series of Poker.

And I think if you look at this next slide you can see that the results of that strategy have obviously been phenomenal. The retail sales in the handle was about \$450 million in 2002, it grew to almost \$700 million in '03 and reached a billion in '04, and we expect that it will exceed \$2 billion in '05.

So this indeed is what new content can do to an activity like the lottery business. And to be perfectly honest, obviously this isn't even an original strategy; this is a strategy that we stole plain and simple from the casino business; this was a lesson obviously that was well worth stealing.

I have absolutely no doubt that this kind of content development can have a similar impact on the racing business, and I take my hat off to Cantor and United Tote for devoting resources to doing that.

To get a sense of what content can do even to the racing industry, we really don't have to look any further than the U.K. Look at what's happened with Betfair, which is as you know, I'm sure, the pioneer in exchange betting; and you can see looking at the slide that the revenues, customer base and operating profits have just literally exploded.

Everybody has their own explanation for why this is. My own view is that it combines the excitement of racing with many of the elements of a sophisticated financial exchange, which is — financial market really — which is what a betting exchange is. You can invest long or short, you can specify the price at which you want to make a trade, you can do spread betting, and so forth.

Right now this activity is available only on the Internet, but I would guess that — obviously, people here that know much more about it than I do, that terminal-based exchange betting in the betting shops and racecourses in the U.K. is not far off, and I would guess that at that point these numbers will go through the roof.

At least every other day somebody comes up to me and tells me that the problem with the racing industry is that racing's too complicated and that the only way we're ever going to get any customers is to dumb down the product. And I suppose in terms of reaching at least some segment of the market that we're now not reaching, but then every market of course is really a composition of many, many segments.

I'm sure there's a segment of the market for which that's true, but I can tell you that exchange betting players are not bums. When they're not betting on the exchange they're trading derivatives and hedge account managers, and they're anything but dumb. And yet they're coming in droves to bet this way. So I think that this is a lesson that we have to learn something from.

Now, I want to say that the reason I was dwelling on this is not because I'm necessarily arguing for or promoting betting exchanges per se. I know a lot of you have issues, valid and good issues with respect to betting exchanges. But I'm dwelling on it because I want to make it clear what the impact of new and different technologies can have in terms of turning around the fortunes of the business.

Ironically, in the U.K., over the last 10 years the share of horse racing betting, relevant sports betting in the betting shops in the U.K. is actually in decline; it's declined from about 90 percent of the total betting, the betting shops in the U.K. 10 years ago, to about 60 percent now. And I would attribute probably three things to that.

One, certainly there's some cannibalization of the betting exchange, but I think not as much as people think. Secondly, I think the racing industry itself in the U.K. has been a little sleepy over the last 10 years. But I think most importantly has been the surging interest in the U.K. and everywhere else in the world of sports betting.

Everywhere I look in the world, organizations, fundamentally racing organizations have been turning to sports betting as a way to augment their growth.

When I asked Steve Beason, our CEO who I was talking about a moment ago, why he felt that the Hong Kong Jockey Club had been able to sustain its historic rate of growth for so long, he said that in fact much of it had to do with sports betting.

We have in the world now something like \$80 billion a year of legal sports betting around the world, growing at a very fast rate. Contrast that with as long ago as 1999; it was estimated that in the United States illegal sports betting was many times greater than the \$80 billion that it is outside the United States.

So obviously keeping it illegal is not stopping it, and nobody can regulate it, know its capacity. I can also give you a couple of other reasons why removing the illegal element of sports betting would be a good idea, but I think if I did in that case the messenger would literally get shot.

So I think sports betting is something that we really need to think very seriously about. If you go back to the early days of racinos, the idea, as I said before, that a racino was a great way and still is a great way to both utilize the assets of a racetrack; but now the experts tell us that for a racino to be really successful it has to have a dedicated facility that has to cost tens of millions if not hundreds of millions of dollars; and by the time we're done the only asset that's being commonly used maybe is the parking lot.

I think sports betting has the ability to perfectly fit the asset infrastructure of this business; the technology that's in place in this business, the people that are in this business, and again I would wholeheartedly argue for giving it consideration.

I think maybe in the same way that the lotteries have been able to make racinos part of their world, in retrospect maybe it was a mistake to call the products that are inside racinos video lottery, because calling it the video lottery was asking for the lottery to make it a part of its domain. But in any case maybe similarly sports betting, if we can ever get it to the track, could in the same way fall under the jurisdiction of the state racing and wagering boards.

I'd like to conclude with just a brief comment about a topic that's been a pet peeve of mine for many years, and that's the issue of distribution.

In the United States right now there are at least a hundred thousand places where you can buy a lottery ticket, compared to literally just a few hundred, well under a thousand in the country where you could bet on a horse race.

And so I think one of the most important reasons why lottery over the last several years has been able to outgrow horse racing is simply because it has 99,000 more retail locations where you can buy it.

The same is true when you look at the international market. In absolute terms, as you can see in the slide, the U.K. and France each have about 15 times, absolutely, the number of retail locations where you can place your bet on a horse race; and if you just bet on the per capita basis, they each have 70 times the concentration of a retail locations.

In the United States, believe it or not, we have two points of betting for every million people. And in the U.K. and France you have more like 140 distribution points per million population.

I myself prefer the French model where they put betting terminals in thousands and thousands of bars and cafes all around France, because I think it makes tremendous economic sense. In the U.K, as I'm sure many of you know, they have

small free-standing retail betting shops, very much like you would see for example in New York City OTBs. And I recently read, it was a speech or a quote that was given to a newspaper, I can't remember which, by someone prominent, and he was saying that he didn't understand why around the world horse racing wasn't much, much bigger business than the lottery.

He said horse racing has an amazingly exciting product, and lottery after all is just basically a boring game of balls jumping out of a machine. And actually he's a hundred percent — thousand percent correct. He's absolutely correct.

But you know, everybody knows the three P's of marketing: Product, promotion and place. And you have the best product in the world, and you can have the best guy in the world, even Frank Stronach promoting your product; but if the product that you consider to be your main competition is available with 99,500 more retail locations than your product is, then you're really fighting with one hand behind your back.

I see where we are really just about out of time, so let me just leave you with a few summary thoughts of what we talked about.

I think we need to be very careful about what we learn from the casino industry. As I said, probably you don't want to hear it anymore; I don't think racino is the savior of the racing industry, or at least I don't think we should be sitting around waiting for the Messiah of the racino to come along to save us.

I do not believe that technology in and of itself is going to be the salvation of this business, even though I personally condone the spending of \$40 million a year trying to do that.

I think we need to exploit the growth in sports betting that's taking place all over the world. Certainly we need to broaden distribution.

And finally, content is king. Is king. Because if there's no new content, then — if there's no new content we can scream about it 'til our faces turn blue, but by the time we're done there'll be nobody there to scream it to. Because without content we just won't ever bring any more customers.

And with that thank you very much. It's been a pleasure talking to you.

(Applause)

I'm happy to answer any questions any of you might have.

A VOICE: Two questions and a comment. First one is, what in your opinion makes horse betting so compelling? What are the aspects of that type of betting that has caused such a great growth in the U.K., what part of betting was that?

And secondly is there — commenting about distribution, obviously sports betting in this country being so big has no or only one area, Las Vegas, I believe, that refuse it, so it sort of seems a bit contra now; it's basically the right content could overcome.

MR. WEIL: Let me actually answer the second one first because I — the first question is, what do I think makes sports betting around the world so compelling? And the second is: With a country as large as the United States, how would we — I'm not getting it right tell me — how would we deal with the area of distribution?

I'll answer the second one first, because actually we've done this in Scientific Games in a number of developing countries all over. I've never seen it done in America or Europe, that doesn't mean it can't be, which is in a number of developing countries we have actually sold, we have developed or managed betting networks that are both lottery networks and horse racing networks, so the shops didn't go into the convenience store, the gas station, whatever it is.

The same terminal can sell, we've done it in Italy, actually quite successfully in Italy. So one answer would be to use the existing distribution infrastructure of the lottery industry to sell horse racing.

One of the things that people are going to be trying to do actually is to see if we can get lotteries to sell to at least 75, you probably know something about that, so that would certainly be one way.

But clearly we have to think outside the box. We're not going to build — I don't think it makes sense to build several thousand or several tens of thousands of New York City kiosks all over the country, I think it has to be something that exploits an existing infrastructure; but certainly the networks of betting rooms would be in bars, restaurants, cafes and so forth.

As far as the first question goes, as to why sports betting sites are so compelling, I really have to tell you that I don't know the answer to that. I imagine there's probably a lot of people here who know. Now David Lee, who recently joined us from Mandalay Bay; David, actually if you want to take a shot at that I'd be happy to let you.

But what I can do with sports betting is simply make the observation; I really don't know what psychologically the content.

Yes?

A VOICE: You said that instant tickets have changed their content over the years, but then all you did was show various logos and brand names. That's not really a change in content, is it? Or is it a change in image?

MR. WEIL: Well, I think it's a change in content for — actually, it's a good question — change in content for several reasons. The first thing that's happened is for

every one of those brands we have designed a game that actually plays in a way that is reminiscent of or — or compose that brand, which is something that was new in the business.

Secondly, we have created very original prize structures that importantly includes merchandise prizes rather than cash prizes, for example, which lotteries never ever did before. And typically these are prizes that you can't otherwise get, you couldn't go out and buy.

So the real portion of the game, you can get to be a contestant on the Wheel of Fortune, on the Texas Hold 'em or the World Series of Poker game you actually get a seat at a million-dollar poker tournament.

And these are things that we basically put together for the lotteries. We go out and find, we create games, we find the merchandise, we present the entire package to the lottery. And then the final thing that we do is, many lotteries use these for so-called second-chance lotteries.

They just become a very big thing. So after you sell several million Harley Davidson tickets all the people that lost mail in their losing tickets and then we'll have a draw; and the winner of the second chance will win a hundred thousand dollar Harley Davidson motorcycle.

So it's really a whole bunch. But it's a very good question and I appreciate your asking.

No more? Okay.

Well, thank you very much, and have great conference.

(Applause)

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