

New York State's \$2 Billion Trifecta:  
NYRA, VLTs & OTB  
Competitive Auctioning of Racing Assets  
Could Narrow NYS Budget Gap

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Maryland Tax Education Foundation

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## EXECUTIVE SUMMARY

Following national trends, New York State has significantly increased the scope of legalized gambling through the authorization of video lottery terminals (VLTs)—in essence, high-tech slot machines by another name—at most racetracks.

Concurrently, the financial cloud surrounding the embattled New York Racing Association (NYRA), which operates the state's three thoroughbred tracks—Belmont, Aqueduct and Saratoga—has jeopardized an important part of the state's horseracing industry and its pari-mutuel betting activity.

VLT expansion and NYRA's uncertain future (along with the future of New York's Off-Track Betting operations) raise serious questions for state policymakers, not least of which involve not only the negative social consequences associated with an increase in gambling opportunities, but also the question of how to maximize taxpayer benefits. But, for better or worse, the policy decision to move in this direction has been made. This report asks whether the state can get a good financial deal by reconfiguring NYRA's operations, increasing the number of VLTs, and privatizing Off-Track Betting (OTB).

In August 2005, the State Legislature created a blue ribbon panel, the Ad Hoc Committee on the Future of Racing, which in January 2006 held hearings in Albany and New York City to facilitate the drafting of its report. In the meantime, NYRA's situation worsened, and in December 2005, the state arranged for a cash infusion to bail out the near-bankrupt NYRA.

New York's racing structure is going to change. That is a certainty. How will it change? Who will end up controlling valuable franchises and properties—and what is the potential value to taxpayers of New York's state-owned racing and wagering assets?<sup>1</sup>

The state's racing and wagering assets (NYRA, VLTs and OTB) could be worth at least \$2.1 billion if these assets were offered at public, competitive, open auction—this is roughly four times the value that Friends of New York Racing (FNYR), a coalition of private racing and wagering interests, suggested in a recent report. A difference of \$1.5 billion in public revenues is not negligible, particularly as the state counts on revenues from expanded VLTs to finance a settlement of New York City's Campaign for Fiscal Equity school finance case.

Clearly, New York State and its citizens benefit from the rich tradition of horse racing at Aqueduct, Belmont and Saratoga, the OTB operations, and related economic activities. The question is one of balance. Certainly, the state wishes to protect the New York horseracing industry, but it must do so in a way consistent with safeguarding the greater interests of taxpayers—i.e., insuring they receive a fair return on the disposal of valuable public assets. An open dialog and a fair, open disposal of valuable public property is a necessity for both the public coffers—and the public trust. As the State of Maryland faces similar issues regarding VLTs and the future of horseracing, the Maryland Tax Education Foundation has sponsored this study.

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1. Some have suggested that the tangible assets of NYRA (i.e. land, tracks and buildings) are not owned by the State of New York. This question is beyond the scope of this report, which assumes state ownership.

## FRIENDS OF NEW YORK RACING PROPOSAL

So far, state officials have been presented with only a single vision of the future of its racing and wagering, that of the Friends of New York Racing. It is a vision that provides taxpayers with less than full value.

According to FNYR, the key to any restructuring of New York's racing industry is the ability to operate VLTs at racetracks. VLTs already operate at smaller harness tracks that are not associated with NYRA.

In June 2005, Friends of New York Racing (FNYR) released a report encouraging the state to authorize slot machine gaming at Belmont racetrack and outlining strategic alternatives for NYRA and OTB. (Such gaming has already been authorized at Aqueduct, and NYRA has contracted with MGM Mirage to operate VLTs at the track, but the machines have not yet been installed.)<sup>2</sup> FNYR issued follow-up reports on November 1 and December 13, 2005.

FNYR suggest the state can sell the slot machine gaming licenses, the tracks, and OTB operations (New York City OTB and all regional OTBs) to private parties for \$465 million. Under this scenario, VLT profits will serve to enlarge the prize money (or "purse") set aside for the owners of horses that win, place or show in a race. This diversion of a portion of VLT revenue, whether from slot operators or from the state taxing authorities, effectively amounts to a large purse subsidy for racehorse owners. New York State harness tracks now operating VLTs already provide such purse subsidies.

The actual combined market value of New York's racing and wagering assets is actually \$2.1 billion—over four times FNYR's estimate—but only if the tracks, slot licenses and OTBs were auctioned to

### Friends of NY Racing Summary

The Friends of New York Racing (FNYR) is a coalition of private racing and wagering interests including thoroughbred breeders and owners, parimutuel betting firms and out-of-state racetrack operators. In 2005, FYNR issued reports, proposing the following:

- Current NYRA assets should be owned and managed by a newly-formed, for-profit business ("Newco"); NYRA does not identify the proposed stockholders of Newco;
- Newco should modernize the operational structure of NYRA's assets, updating its physical plant;
- Each of the six regional OTBs should merge with Newco to streamline the state's pari-mutuel betting business;
- Belmont Park should be awarded a new VLT machine franchise to complement MGM-Mirage's existing, but yet to be implemented, VLT franchise at Aqueduct racetrack. The dual franchises should represent a gaming monopoly in densely populated Kings, Queens, Nassau and Suffolk counties, thus ensuring Newco's profitability and ability to attempt a revival of the NYRA's racing business;
- Allocate 7.5% of the slots revenue (about \$130 million per year) to doubling the size of Aqueduct, Belmont and Saratoga purses, under the theory that higher purses stimulate horse racing activity;
- Newco should pay the state and localities \$465 million in cash for the three tracks, two VLT franchises and six OTB operations. Alternatively, Newco should pay a smaller amount and allow the state and localities to retain a partial ownership interest.

2. MGM Mirage's contract to operate VLTs at Aqueduct was approved by the State Lottery Commission on December 30, 2005. Nevertheless, both MGM and NYRA require a VLT operator's license. NYRA's criminal indictment and deferred prosecution arrangement may complicate the awarding of such a license.

### Off-Track Betting (OTB)

Off-Track Betting has allowed New Yorkers to legally gamble at government-operated betting parlors (and by phone) for decades. Bettors may wager on both New York State and out-of-state tracks.

New York State's six regional Off-Track Betting Corporations trace their development to April 1970 legislation signed by Gov. Nelson Rockefeller. When New York City OTB opened its doors on April 8, 1971, it was the nation's first legal off-track pari-mutuel wagering operation.

The City of Schenectady OTB (now the Capital District Regional OTB) also began operations in 1971, followed by Western Regional OTB (1974), Nassau Downs OTB (January 1975), Suffolk Regional OTB (April 1975) and Catskill Regional OTB (1976).

The state's OTBs explain their mission as threefold: "to raise needed revenue for [their sponsoring governments], to combat organized crime's hold on gambling by providing a legal alternative and to help New York State's racing industry."

Simulcasting to OTB parlors initially consisted of audio signals. The Legislature experimentally authorized live audiovisual signals in 1984 and permanently authorized them in 1990.

Regional OTB	2004 Regional OTB Total Handle	
	Simulcast Branches	Total Handle
Capital District	44	\$212,235,503
Catskill	23	\$143,119,690
Nassau	13	\$299,355,534
NYC	65	\$1,036,088,072
Suffolk	13	\$205,292,864
Western	37	\$149,541,572
<b>Total</b>	<b>195</b>	<b>\$2,045,633,235</b>

the highest qualified bidders and if the purse subsidies were reduced. Essentially, FNYR's proposal is a massive wealth transfer to private gaming interests that may or may not use the money to improve racing.

The evidence to date suggests that slot machines and VLTs at racetracks enrich track owners and racehorse owners but do little to stimulate in-state racing activity, defined as added racing days, live attendance, live handle, and in-state breeding.<sup>3</sup> Indeed, VLTs' immense profitability, relative to horseracing, consigns the latter to secondary status at so-called "racinos." By way of example, since Dover Downs in Delaware began its slots operation in late 1995, capital expenditures for slots have exceeded those at the horse track by a factor of 20:1.<sup>4</sup>

Further, no inherent connection exists between casino-style gaming and pari-mutuel betting. There is little "crossover" between individuals playing slots or VLTs—rapid game of random

3. "Horseracing and Casino-Style Gambling: Facts Behind the Myths," published by the Maryland Tax Education Foundation, November 11, 2003. The report examined Delaware and West Virginia tracks before, and after, slot machines were introduced.

4. Dover Downs Entertainment (and predecessor) filings with the U.S. Securities and Exchange Commission.

chance—and those betting horses—an activity requiring handicapping skill and extended study time.<sup>5</sup> Rather than give a gaming monopoly to tracks for the sake of “saving jobs,” New York could just as easily assign slot machines to ailing airlines or health care facilities.

Even if the Legislature somehow untangles FNYR's flawed reasoning, the state's cost of saving “NYRA-related horseracing jobs” would be astounding. Based on the activity at Aqueduct, Belmont and Saratoga, and the level of thoroughbred racehorse breeding in New York State, a reasonable estimate of directly and indirectly attributable jobs is 7,000, based on job studies of horseracing in Pennsylvania and Maryland (compared to an FNYR's estimate that 35,000 jobs are involved in the state horse industry).<sup>6</sup> Assuming one half of the jobs would be “lost” without implementing the FNYR proposal, the initial cost per “saved job” works out to \$475,000, followed by purse subsidies each year totaling \$130 million, or \$37,000 annually per saved job.

Clearly, the State of New York and its citizens benefit from a rich thoroughbred tradition, VLTs, OTB, and related economic activities. However, before providing a massive wealth transfer that may or may not be applied to horseracing improvements, state policymakers should examine other less costly, and perhaps more effective, means of supporting horseracing and horse breeding—and, last, but certainly not least, the state treasury.

## AUCTION VALUE OF SLOTS LICENSES IN QUEENS AND LONG ISLAND

The vast profit potential of VLT in New York reflects laws of supply and demand. Laws limiting VLT locations are a barrier to supply. Because demand is strong, a large producer surplus accrues for legal operators, a surplus generating tremendous potential profits for the two tracks that hold monopoly power over the Queens, Brooklyn, and Long Island markets.

When government and special interest groups work together to allow gaming at a small number of venues, they create gaming monopolies that capture profits differently from how a competitive market would. The government's ability to establish gaming monopolies and then tax the enormous profits gives it the ability to generate and extract money for public use. Game operators eager to receive a portion of the casino revenue usually accept the state's conditions because they profit along with government. Operators strive for low gaming taxes, in order to increase the value of their franchises. The only loser is the gaming consumer, who receives lower odds of “winning” and fewer amenities than in competitive gaming markets.

From a free-market standpoint, state legalization of casino gaming under constrained market conditions is troubling. Libertarian free market advocates argue that gambling, like any other product, should only be regulated by special taxes or supply restrictions where there is a clear and compelling need to control a market failure. After that, consumers should be free to enjoy the surplus that they would gain from competition. At the same time, the state should avoid manipulating markets to produce benefits for owners or the state itself. Governments, however, see it differently and invariably intervene in markets to extract revenue or distribute benefits.

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5. The lack of crossover is an acknowledged fact among executives in the gaming industry. Two academics who have examined the lack of crossover from slots to horses and who have gone on record are (a) Professor William Eadington, Director of the Institute for the Study of Gaming and Commercial Gaming at the University of Nevada, Reno, and (b) Professor Richard Thalheimer of the Equine Industry Program at the University of Louisville.

6. “Pennsylvania Equine Inventory, Basic Economic and Demographic Characteristics,” Pennsylvania State University, College of Agricultural Sciences (May 2003) and “Economic Impact of Horse Racing in Maryland,” Center for Agricultural and Natural Resource Policy, University of Maryland (1999).

Consumer protection or safety is usually given as the prime rationale for government regulation of a product or service that free markets could provide on an otherwise unrestricted basis. But in the case of gambling, policymakers justify regulation principally as a way to maximize government revenues—without regard for the impact on consumers.

Under the current regulatory regime for gaming in New York, an explicit goal is to limit the supply and limit competition among gambling venues. In exchange for those profit-maximizing limits, the state imposes special taxes to capture some of the profits for the public benefit. Given that reality, we undertake this study to determine how New York could best manage the monopoly profits from the expansion of VLT gaming into Queens County (Aqueeduct) and Nassau County (Belmont), respectively.

In this scenario, the state auctions slots licenses that must be utilized on, or nearby, the racetrack properties. The MGM-Mirage agreement with NYRA is not implemented; however, MGM, along with other qualified companies, would be allowed to bid on a VLT license.

### **Typical Technique for Auctioning Major Government-Operated Businesses**

If New York State government went to public auction to dispose of its racing/gaming operations and to maximize returns, it might approach the process as follows:

1. Engage an experienced appraisal firm or investment bank to estimate the value of the government businesses.
2. If the values meet the government's expectations, the government retains a financial advisor (usually an investment bank, corporate finance advisory firm or the merger and acquisition department of a commercial bank) with knowledge of corporate valuation and the sale process. For example, in January 2005, the City of Chicago sold the Chicago Skyway tollroad for \$1.8 billion. In January 2006, the state of Indiana sold the Indiana Toll Road for \$3.8 billion. The financial advisor on both deals was Goldman Sachs.
3. The advisor augments the initial valuation work by completing its own due diligence. The advisor then prepares an information memorandum describing the business and works concurrently with the government to develop a list of potential buyers (prescreened for financial strength), as well as any special conditions attached to the sale for public policy reasons.
4. The advisor contacts between 50 and 100 potential buyers, including operating companies, private equity firms and hedge funds. Depending on the nature of the assets, the list may include domestic as well as foreign buyers. The stark difference between VLT franchises, horseracing operations and OTB assets will require three separate auctions to maximize cash proceeds.
5. The advisor contacts potential buyers, informs them of the pending sale of the businesses and tells them of the government's price expectations. Perhaps 1 in 3 of those contacted will request an information memorandum.
6. After an additional exchange of information between the potential buyers and the government's advisor, perhaps, only one half of the remaining potential buyers remain. Thus, an auction beginning with 50 potential buyers will produce 8 or 9 real bidders.
7. Selected parts of this sequence were followed by the Board of Directors of Well Choice. Well Choice was the New York-based Blue Cross Blue Shield health insurer that was 62% owned by the State of New York when it was sold to Wellpoint, Inc., another large Blue Cross Blue Shield provider, in December 2005 for \$6.2 billion.

**METHODOLOGY** To carry out our analysis, we projected the annual gross revenue per new slot machine. We used data from current slots operations in other well-populated metropolitan areas in the United States and Canada, and then adjusted those data in accordance with demographics and anticipated New York slots parlor locations.

Using those numbers, we also assumed that the state gaming licenses in question would have a term of 20 years, and we made other assumptions that are standard in a business analysis of this sort (as explained below). We then modeled the financial results of each gaming market design.

Our financial analysis uses projection techniques that are widely accepted by corporate appraisers, valuation experts, and financiers. The principal assumptions behind the revenues per machine, slots facility operating expenses, and required capital investments are clearly identified in the accompanying tables.

To carry out this analysis, we made the following assumptions about the gaming market:

- **Number of machines** To enhance the value of the monopolies being sold, the State limits the number of machines at each location, and the state guarantees no further expansion of gaming for a specified period. We hypothesize that the Aqueduct and Belmont locations would have 4,500 and 5,000 VLTs, respectively, for a total of 9,500 new slot machines. (Connecticut's Mohegan Sun and Foxwood casinos each have over 6,000 machines.<sup>7</sup>) We further hypothesized that table games would not be permitted at the new locations.
- **Locations** The VLT facilities would be located adjacent to, or nearby, the track properties. To enhance auction proceeds, the State of New York would pass a law legalizing VLTs at nearby locations (Governor Pataki's proposed 2006-07 Budget seems to support this assumption.)
- **Win per day per machine** We assume that gross profits after prize payouts (also known as the "win per day" or WPD) per machine will be \$500 at Aqueduct and \$500 at Belmont. Those numbers are projected using the experience of casinos and track/gaming facilities (commonly called "racinos") in similar areas and the population base per installed machine. Win per day is a very common statistic used in the gaming industry to measure the relative productivity of a slot machine. The statistic is widely available on state gaming commission websites, SEC filings of gaming companies and gaming analyst reports.

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7. Division of Special Revenue, State of Connecticut.

Tables 1 and 2 set forth the relevant market for the machines.

**Table 1: Population of Local Market for Two Slots Facilities**

County	(A) % of Population in Market Base (Weight)	(B) Population (in 1,000s)	(A) x (B) Relevant Market Population (in 1,000s)
Nassau	100%	1,562	1,562
Suffolk	100%	1,475	1,475
Kings (Brooklyn)	100%	2,475	2,475
Queens	75%	2,237	1,678
Richmond (S.I.)	50%	463	232
New York (Manh.)	25%	1,562	391
			<u>7,813</u>

**Source:** U.S. Census Bureau for population. The authors assigned the percentage weightings.

As Table 1 indicates, we assign a less-than-100% weight to Queens and Manhattan, as the Yonkers racino is more convenient for a portion of those populations. Thus, the captive market for the two monopoly slots franchises is 7.8 million people. With an assumed 9,500 VLTs, the population per VLT is 822. Table 2 shows WPD of comparable metro areas and estimated WPD for Aqueduct and Belmont.

**Table 2: Comparative Metro Areas with Slot Machines**

Metro Area	Population per Slot Machine	Average WPD per Slot Machine
Chicago	600	\$450
Detroit	450	\$350
St. Louis	300	\$240
Queens (Aqueduct)	822	\$500 (Est.)
Nassau (Belmont)	822	\$500 (Est.)

**Source:** U.S. Census, State gaming authorities, federal securities filings, and authors' calculations

At a maximum of 9,500 VLTs, the market we envision has one VLT for every 822 residents. The estimated WPD per VLT is \$500. A higher number might be used in light of the New York market's larger population per machine, but the New York racinos lack the attraction of table games offered in the Chicago, Detroit and St. Louis markets.

The projected Aqueduct/Belmont WPD is much higher than WPDs experienced at the Monticello and Saratoga racinos (based at harness tracks). The difference is a product of the far greater population base that Queens/Nassau draws upon.

The Mohegan Sun and Foxwood casinos together operate 13,541 slot machines. The average WPD per machine was \$352 in 2005.<sup>8</sup> The two Rhode Island racinos, Lincoln Park and Newport

Grand, together operate over 4,000 machines and recorded a 2005 WPD per machine of about \$335.<sup>9</sup> All four facilities draw heavily from large urban markets located 40–90 miles away, perhaps an hour's drive or more.

Two slot oligopoly facilities in Chicago have shown WPDs in excess of \$600.<sup>10</sup> With the convenience that two of the facilities would provide to consumers in the New York metropolitan area, the projected \$500 WPD is reasonable.

Table 3 shows our projected revenues from slots for the two facilities. These numbers represent the total gross revenue (after prize payouts but before taxes, lottery administrative fees, operating costs, etc.) for the two facilities.

**Table 3: Win Per Day Per VLT**

Location	Total Number of VLTs	WPD per Machine	Annual Net Revenue (millions)
Aqueduct	4,500	\$500	\$ 821
Belmont	5,000	\$500	\$ 913
			\$1,734

**Source:** Authors' estimates.

*Time:* We assume that it will take three years for the two gaming sites to reach full operational capacity. Hence, we assume that the locations will generate only 50% of projected annual revenue in their first year of operation and only 75% in their second year.

*Inflation:* We assume inflation will average 3% annually; and, thus, the “win” increases 3% annually upon full capacity operation.

*Capital Expenditures:* For the two racinos, we assume a combined upfront capital investment of \$200 million, or \$100 million cash.

The \$100 million cost per facility is lower than MGM-Mirage's \$170 million estimate for an Aqueduct racino because the \$170 million includes significant costs for amenities such as retail, restaurant and entertainment.<sup>11</sup> We assume these amenities generate their own income streams and will be self-financing. At each site, we assume a 200,000 square foot facility costing \$350 per foot of enclosed space, plus parking lot expenses.

Except land, capital investment has an average 12-year economic life for depreciation purposes. Depreciation is a non-cash expense.

*Cash Operating Costs:* We assume each machine has a daily cash operating cost of \$75. That number is corroborated by the federal securities filings of two gaming companies operating slots parlors; filings provided to the Pennsylvania Gaming Commission by prospective racino operations, documents provided to the Maryland legislature by prospective racino operations, press releases and SEC filings of gaming firms. Note that the cost of machine leasing is borne by the state lottery, which collects an administrative fee.

8. Division of Special Revenue, State of Connecticut.

9. Rhode Island Lottery.

10. Illinois Gaming Commission.

11. MGM project and management agreement with NYRA, as filed with SEC.

*State Gaming Tax:* The state gaming tax (allocated to education) for each facility is 54.0% on the first \$50 million of win, 57.0% on the next \$100 million and 60.0% on win over \$150 million, net of marketing allowance.

*Marketing Allowance:* Assume the State equalizes both facilities at 4%. Upstate slots operators receive 8%.

*Lottery Administrative Fee:* The lottery administrative fee is 10.0% of the win, which pays for the leasing of the machines, among other items. After state gaming taxes, marketing allowance and administrative fee, the operators receive 36.0% of the first \$50 million of win.

*Purses and Breeder Awards:* In November 2005, the NYRA, New York Thoroughbred Horseman's Association (NYTHA) and New York Breeding and Development Fund (Fund) announced a revenue sharing agreement for the distribution of VLT revenue from the proposed MGM-Aqueduct racino.<sup>12</sup> Through higher purses, the horsemen will receive 7.50% of VLT win in year 1 (of operation), climbing to 10.00% in year 6 (and thereafter). The Fund will receive 1.25% of the win in years 1-5, followed by 1.50% thereafter. The total share after year 5 for both the horsemen and fund will be 11.50%.

In its financial projections, which assumed VLTs at Aqueduct and Belmont, FNYR assumed that this 11.50% is reduced to 7.5%.<sup>13</sup> Based on our projection of \$1,734 million in annual slots win, even the lower 7.5% share provides a purse subsidy to racehorse owners of \$130 million per year. Capitalizing this annual amount at 8% indicates a present value subsidy equal to \$1.6 billion.

A reasonable assumption is that many of the racehorse owners are far more wealthy than the average New York resident and that the New York Legislature may find it difficult to approve such a subsidy, or wealth transfer. Accordingly, this analysis uses a 2.5% allocation to the purses and the Fund.

*Non Slots Income:* We assume the facilities will have 25 million visitors per year, losing on average \$70 per visit on VLTs and spending \$6 per visit on non-VLT items such as food and beverage. We assume the VLT operator will receive a 10% commission on non-slots revenue.

*Assumptions:* The WPD, construction cost and operating expense assumptions are corroborated by verifiable data obtained from audited filings with the U.S. Securities and Exchange Commission, audited reports from various state gaming commission Web sites, racino proposals made to various state governments, statistics from the U.S. Census Bureau, and selected newspaper and magazine articles. To complement the data, the authors interviewed selected industry participants and analysts.

## PROJECTED EARNINGS OF VLT OPERATORS

The projected revenues, earnings before interest, taxes, depreciation, and amortization (EBITDA),<sup>14</sup> and net income VLT operators are set forth in Table 4. Note that VLT operators receive only a portion of total slots revenue. The remainder is allocated to state gaming taxes, administrative fees, purses and breeding funds.

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12. See NYRA press release dated November 3, 2005.

13. "The Way Forward," December 2005, FNYR.

14. EBITDA is a widely used statistic in corporate financial analysis and valuation.

**Table 4: Projected Income of VLT Operators** (In Millions)

	<b>Aqueduct</b>	<b>Belmont</b>
Total VLT Revenue ("Win")	\$ 821	\$ 913
State Gaming Taxes <sup>15</sup>	487	542
State Administrative Fee	82	91
Purses and Breeding Fund	<u>21</u>	<u>23</u>
Revenue Share to Slots Operators	231	257
Non-Slots Income	15	15
Less Cash Operating Costs	<u>(123)</u>	<u>(137)</u>
EBITDA	123	135
Fixed Asset Depreciation <sup>16</sup>	(8)	(8)
Pre-tax Income	115	127
Income Taxes at 40%	<u>(46)</u>	<u>(51)</u>
Net Income	<u>\$ 69</u>	<u>\$ 76</u>

Source: Authors' calculations

## PROCEEDS FROM CASH AUCTION OF VLT LICENSES

Under a Cash Auction, New York awards the two VLT operating licenses to the bidders offering the most upfront cash to the state as a "licensing fee." Each license allows its holder to operate at Aqueduct and Belmont or at nearby non-track locations. The auction's terms stipulate that the operators receive a specific percent of the win, with the remainder going to state gaming taxes, administrative fees, purses and breeding funds. Bidders are subject to a rigorous pre-qualification procedure to ensure that they have sufficient cash to finance their bids and have spotless reputations and legal histories.

To ensure professionalism, maximize proceeds, and minimize bid rigging, the auction of each license is conducted on the state's behalf by a nationally recognized investment bank.

**EXPERIENCES ELSEWHERE** To project the winning bids, we looked at media accounts and securities filings of recent sales of oligopoly gaming licenses in locations elsewhere in the United States that have population density statistics comparable to Queens County and Nassau County. Those sales prices are indicative of what potential gaming operators would bid in a cash auction. Several good comparisons are listed below. Note that slot machines/VLTs represent about 80% of a casino's profit, so the value of a casino license is similar to a slots/VLT license.

**Pittsburgh, Pa. (November 2005)** Oaktree Capital and controlling shareholders of Millennium Gaming acquired the Meadows racetrack from Magna Entertainment for \$225 million. The horseracing operations were then subcontracted back to Magna. The acquirers were responsi-

15. The effects of the state marketing allowance are incorporated herein.

16. The analysis excludes the potential amortization expense that a slots operator might realize by paying an upfront licensing fee, which might be tax-deductible.

ble for building the racino and paying the state a \$50 million license fee. Pennsylvania allows a racino operator to retain approximately 48% of the win. Hence, the value of the slots operation at Meadows can be understood to equal (a) the sale price paid by Oaktree to Magna plus (b) the license fee to be paid to the State of Pennsylvania minus (c) the estimated \$30 million value of the track's tangible assets, such as land and buildings. The implied cost of the license is thus \$245 million.

**Pocono Downs, Pa. (October 2004)** The Mohegan Indian tribe, owners of the Mohegan Sun casino, acquired Pocono Downs for \$330 million. The tribe must pay for building the racino and paying the state's \$50 million license fee. Including its land value, the harness track as a stand-alone business has an estimated \$40 million value, setting the license value at \$340 million.

**Philadelphia, Pa. (July 2004)** Three weeks after the Pennsylvania legislature legalized slot machines at racetracks, Harrah's Entertainment announced its intention to acquire a 50 percent interest in a local harness racetrack license. To be located in Chester, a suburban Philadelphia town, the track was not yet constructed, nor was its land purchased. Based on Harrah's recent SEC filings, it has invested \$392 million to date for its 50 percent of the license, essentially financing all the tangible assets, such as

## VLTs

VLTs (Video Lottery Terminals) are gambling devices similar to slot machines but with the game and pay-out completely computer generated.

The similarity to slot machines created a grave hurdle for the installation of VLTs in New York State, as slot machines are banned by the state's constitution. In May 2005, however, the state's highest court, the Court of Appeals, ruled 5-2 that VLTs are not slot machines but rather a form of video game.

In New York State, VLTs are operational at:

- Monticello Raceway (1,800 VLTs)
- Saratoga Gaming and Raceway (1,324 VLTs)
- Finger Lakes Gaming and Raceway (1,010 VLTs)
- Fairgrounds Raceway and Gaming (near Buffalo) (990 VLTs).

Saratoga Springs' Saratoga Gaming and Raceway initiated VLTs on January 29, 2004. Bets may be made in amounts ranging from one cent to \$10. Payout is in the 90% range. Roughly \$1 billion was bet at Saratoga Gaming and Raceway's 1,324 VLTs in 2004, and that amount doubled in 2005.

"The roughly \$1 billion wagered in 2004 generated \$82 million for the New York State Lottery, which oversees gaming operations," noted *The Saratogian*, "Of that, 61 percent, or \$50 million, supported state education." Saratoga's VLTs now attracts 50,000 bettors per week or 2.5 million annually.

Sullivan County's Monticello Raceway operates 1,800 VLTs but, for a variety of reasons, (primarily competition from Atlantic City and Connecticut gambling operations) it has failed to generate the crowds created by Saratoga Gaming and Raceway.

The above mentioned constitutional issues have delayed installation of VLTs at Yonkers Raceway (4,000 VLTs) and Aqueduct (4,500 VLTs to be operated by MGM Mirage). "The Division of Lottery is reviewing NYRA's application and its casino management deal with MGM Mirage," the *Albany Times Union* wrote in December 2005. "NYRA has been criticized by state officials for failing to follow competitive bidding procedures when it awarded MGM the contract."

land, racetrack facilities, slots buildings and related amenities, such as shopping, restaurants and entertainment. The intangible value of the other 50 percent of the joint venture (i.e., the slots license) is thus worth \$392 million plus Harrah's eventual payment for the \$50 million slots licensing fee, or \$442 million.

**Chicago, Ill. (March 2004)** Through an auction conducted by New York investment banker Rothschild, Inc., the State of Illinois sold a casino license for a location in metropolitan Chicago for \$518 million to the gaming firm Isle of Capri Casinos. The license allows only 1,200 slots and 60 table games (vis-à-vis a proposed Queens/Nassau license that would allow 5,000 slots but no table games). Illinois permits casinos to hold portions of the win on a graduated basis; on average, the hold ratio for an operator with \$400 million in revenue is approximately 46 percent. The auction was recently cancelled because of non-auction-related legal problems associated with the license.

**Lawrenceburg, Ind. (January 2001)** Argosy Gaming bought a partial stake in a riverboat gaming operation from previous owners who acquired their operating license for free. The value of the license can thus be determined by subtracting the construction costs of the riverboat casino and related improvements from the purchase price that the buyer paid to the sellers. Argosy bought 42.4 percent of the Lawrenceburg riverboat casino for \$368 million (indicating that 100 percent was worth \$876 million). Assuming a \$70 million cost for the riverboat and \$60 million for the hotel and parking lot, the value of the license was on the order of \$750 million, mainly because of the riverboat's monopoly power in the more populated Cincinnati market. The riverboat has 2,246 slots and 95 table games. Indiana has a lower betting tax than New York.

**Detroit, Mich. (November 2000)** Two businessmen, Ted Gatzaros and Dimitrois Papas, sold their 40 percent interest in a Detroit casino license (obtained for free) to the Sault Ste. Marie Chippewa Tribe (which operates five casinos) for \$265 million. If 40 percent is worth \$265 million, a 100 percent interest is therefore valued at \$663 million. The license permitted 2,200 slots and 100 table games in a state that allows a hold rate of about 70 percent. No tangible assets were involved in the transaction as the casino had yet to begin construction or land acquisition.

The six transactions above provide a valuation range of \$245 million to \$750 million for the license to operate gaming. In New York's case, the higher gaming tax lowers the license values, but we believe this reduction is outweighed by the fact that the slots operators will operate two monopolies in a market of 7.8 million people.

In addition to considering recent sales of gaming licenses, we estimated what buyers would pay for the projected income of the slots monopolies. Racino and casino stocks trade publicly at six to 14 times EBITDA. Gaming firms tend to acquire other gaming properties at eight to 12 times EBITDA.

To be conservative, we assumed that potential buyers would value a metropolitan New York gaming facility at nine times EBITDA. We then deducted a 15 percent "start-up" discount for risks of the unknown, which is reasonable for such an analysis; a 15 percent discount because full operation is not attained until the third year; and the relevant up-front capital costs.

**Results** Given those numbers and assumptions, our modeling indicates the two New York licenses have a total cash value of \$1.4 billion. That calculation is depicted in Table 5.

Table 5: Estimated State Cash Proceeds at Auction (In Millions)

	Queens	Nassau
EBITDA	\$ 123	\$ 135
Bid Calculation		
9x EBITDA	1,107	1,215
Less 15% "Unknown" Discount	(166)	(182)
Less 15% "Early Years" Discount	(166)	(182)
Less Fixed Assets Cost	<u>(100)</u>	<u>(100)</u>
Auction Values for a Single License	\$ 675	\$ 751

Source: Authors' calculations

## PROCEEDS FROM AUCTION OF AQUEDUCT AND BELMONT RACING OPERATIONS

Having determined the likely auction value of the slots licenses, we now turn to the question of the potential value of the Aqueduct, Belmont and Saratoga racetracks. As noted earlier, we assume that the NYRA franchise includes the tangible assets of the tracks, such as the land and buildings. The real estate ownership, however, is a matter of dispute, regarding the rights of the State of New York.

To ascertain that value, we assume racing continues indefinitely at each track. However, the future operating, regulatory and tax regime is uncertain, and this uncertainty complicates an appraisal of the business because a prospective owner is unsure of the future earnings power of the tracks.

To develop a general sense of the tracks' value, we utilize three valuation approaches: income, comparable sales and real estate.

**INCOME ANALYSIS** The New York Racing Association holds a monopoly on thoroughbred racing in one of the most densely populated areas in the United States. Nevertheless, in 2003 and 2004, the New York Racing Association lost \$22.1 million and \$16.0 million, respectively. As of December 31, 2004, the Association's accumulated deficit was \$102.2 million.<sup>17</sup>

Although the association generates over \$150 million in gross profits per year from its two tracks, its general and administrative costs, as a percentage of gross profit, are higher than similar operations run by commercial track operators Churchill Downs and Magna Entertainment, according to those firms' corporate filings. This suggests that a privately run association could lower costs and eventually generate a profit, as do the tracks hosting the other two legs of the Triple Crown (Churchill Downs and Pimlico).

Accordingly, we conclude that the three tracks have the potential to be profitable under new ownership. However, estimating the exact level of future profitability is conjectural at this time because of the level of uncertainty surrounding the regulatory regime.

17. NYRA audited financial statements as filed with New York State authorities.

**COMPARABLE SALES ANALYSIS** Since December 1998, Magna Entertainment has acquired six large racetrack operations in North America: Santa Anita Park near Los Angeles, Gulfstream Park near Miami, Golden Gate Fields near San Francisco, Lone Star Park near Dallas, and the Maryland Jockey Club, which operates Laurel Park, near Washington, D.C., and Pimlico Race Course in Baltimore. Magna bought all the land on which the tracks are located, with the exception of Lone Star Park.<sup>18</sup>

The purchase prices of Laurel and Pimlico (\$170 million combined if applied to a 100% interest), Lone Star (\$79 million) and Gulfstream (\$81 million) reflect Magna's interest in horse racing operations, as well as developing excess land owned by the tracks and promoting the installation of thousands of slot machines at the tracks. The average price of the four tracks was \$83 million.

We assign 20% of the acquisitions' value to the possibility of gaining lucrative slots operations (which Magna has already achieved in Florida, Oklahoma and Pennsylvania and is lobbying for in Maryland). Thus, a rough estimate of a single major track's acquisition value (including land) without slots is approximately \$66 million. Because this analysis separates VLT franchises from racetracks, this number is a reasonable approximation for Aqueduct and Belmont, respectively. For Saratoga, with its limited meet, we assign a 60% weighting. The combined total for the three tracks is thus \$172 million under the comparable sales method.

**REAL ESTATE ANALYSIS** Aqueduct Racetrack includes approximately 76 acres in densely populated Queens County. Belmont Park includes 430 acres in densely populated Nassau County. Saratoga includes 300 acres in Saratoga Springs. Based on sale prices of nearby homes, NYRA's recent estimate of the market value of nine acres of excess land at Aqueduct, NYRA's recent pronouncement on the \$1-2 billion market value of all its real estate, and the City of Saratoga Springs assessment of NYRA's real estate there, we assign the following values, assuming the land can be rezoned for best use. We assign a 30% discount for the cost of subdividing the land and readying it for development. See Table 6.

**Table 6: Real Estate Values for NYRA**  
(In millions)

Tracks	Acreage	Value Per Acre Finished	Discount for Subdivision, Utilities and Other Development Work	Sale Value "As Is"
Aqueduct	76	\$ 2.5	30%	\$ 133.0
Belmont	430	1.5	30%	451.5
Saratoga <sup>a</sup>	300	---	---	<u>50.0</u>
			Total	\$634.5

a. The City of Saratoga Springs assesses at 100% of estimated market value.

**Source:** Authors' estimates, NYRA estimates, City of Saratoga Springs.

18. SEC filings of Magna Entertainment.

By way of reference, five single-family home lots of 8,000 square feet occupy approximately one acre.

Closing the track facilities, funding employee pensions, demolishing the tracks and changing the zoning might require \$200 million. Accordingly, as a real estate investment, we project that the tracks have a value of \$434 million (i.e. \$634.5 - \$200.0).

**CONCLUSION** Averaging the \$172 million “comparable sale value” and the \$434 million “real estate” value, we project a \$303 million value for the three tracks without slots licenses.

## NEW YORK STATE OTB OPERATIONS

There are six regional OTB corporations (Capital District, Catskill, Nassau, NYC, Suffolk, and Western New York). On a collective basis, these regional corporations have been profitable, even after paying pari-mutuel taxes and surcharge taxes.

Handle and gross profit for the OTBs were flat from 2000 to 2004. Operating expenses increased with inflation over that time, and payments to the horse industry rose. As a result, OTB payments to localities (i.e., profits) steadily declined. See Table 7.

**Table 7: New York State OTB Trends (in Millions)**

	2000	2001	2002	2003	2004
Statewide OTB Handle	\$1,975	\$2,010	\$2,043	\$2,022	\$2,046
OTB Gross Revenues	508	505	502	494	500
Industry Payments	169	175	175	175	182
Operating/Cap. Exp.	218	225	229	230	242
NY State Fees/Taxes	24	25	25	29	31
To Localities (Profits)	97	80	73	61	45

**Source:** NY State Racing and Wagering Board Annual Reports.

Privatization of OTB will draw significant investor interest from local and international gaming concerns. The huge success of the Connecticut OTB sale provides a positive precedent. Furthermore, New York's sizeable \$2 billion handle and the OTBs' prior profitability will give investors confidence in a prospective turnaround.

An investor might reasonably assume that the New York State OTB operations could achieve an EBITDA margin of 4%–7% on OTB handle, given that Connecticut OTB achieves 7%.<sup>19</sup> This translates into an EBITDA of \$80 million to \$140 million, before any growth in handle is assumed.

Publicly traded betting operations in England trade at approximately 10 times EBITDA. An investor in OTB would likely pay one-half of this multiple (or 5x) for New York's minimum prospective EBITDA. Thus, a reasonable auction value is \$400 million for the combined OTB operations.

19. Scientific Games 2004 SEC filings and Division of Special Revenue, State of Connecticut.

**CONCLUSION** This report concludes that the likely cash auction value of the two slots licenses, the three NYRA tracks and the OTB operations is \$2.1 billion, as set forth below:

	(Billions)
Two VLT Licenses	\$ 1.426
Three NYRA Tracks	.303
OTB Operations	<u>.400</u>
	\$2.129

Three separate auctions will be required to the differences of the three asset categories. Subsequent to the auctions, states and localities can expect to realize ongoing revenue from gaming taxes, parimutual taxes, income taxes and other taxes related to the successor operations.

The New York racing and breeding industries are significant employers statewide, and those portions of the industry related directly to NYRA account for approximately 7,000 jobs. Furthermore, NYRA's racing activity represents a long-standing component of the state's tradition and culture comprising part of the state's tourism portfolio. This report assigns a direct subsidy of 2.5% of annual VLT win toward higher purses and larger breeder funds. Other mechanisms also exist for the State of New York to subsidize these industries or to reduce their tax burdens.

## ABOUT THE AUTHORS

**Jeffrey C. Hooke**, managing director of Hooke Associates, LLC, an investment bank based in McLean, Va., is chairman of the Maryland Tax Education Foundation ([www.marylandtaxeducation.org](http://www.marylandtaxeducation.org)). Previously, Hooke was a director of Emerging Markets Partnership (a \$5 billion private equity partnership), a principal investment officer of the World Bank Group, and an investment banker with Lehman Brothers and Schroder Wertheim, respectively, two prominent New York-based securities firms.

Hooke is the author of three books: *The Emerging Markets* (2001), *Security Analysis on Wall Street* (1998), and *M&A: A Practical Guide to Doing the Deal* (1996), all published by John Wiley & Sons. His studies on casino-style gaming have led to testimony on the value of gaming licenses and the prospective revenues from state-sanctioned gaming expansion before the legislatures of Maryland, Massachusetts, Pennsylvania and Texas. His views on state-sanctioned gaming expansion have been referenced in numerous publications, including the *New York Times*, *Forbes*, *Washington Post*, *Chicago Sun Times*, *Philadelphia Inquirer*, *Houston Chronicle*, *Baltimore Sun*, *Dallas Morning Post*, *Cleveland Plain Dealer*, *Boston Globe*, *Miami Herald*, *Fort Lauderdale Sun Sentinel* and *Pittsburgh Post-Gazette*.

**Thomas A. Firey** is the managing editor of *Regulation* magazine, a publication of the Cato Institute ([www.cato.org](http://www.cato.org)), and also is a senior fellow of The Maryland Public Policy Institute ([www.mdpolicy.org](http://www.mdpolicy.org)).

Hooke and Firey co-authored the August 2003 report "Legalizing Video Slot Gaming in Maryland: A Business Analysis," (published jointly by the Maryland Tax Education Foundation and the Maryland Public Policy Institute), the October 2004 report, "Expanding Slot Gaming in California: Business Analysis" (published by the Reason Foundation), and the April 2005 report, "The State Legislature May Leave \$4.5 Billion on the Table by Not Setting a Fair State Gaming Tax," (published by Florida Tax Watch).

## ABOUT THE SPONSOR

The Maryland Tax Education Foundation is a non partisan, non profit research institute that focuses on tax and budget issues regarding local and state government in the State of Maryland. The web site of the foundation is [www.marylandtaxeducation.org](http://www.marylandtaxeducation.org). The Foundation receives no contributions from racing or gaming interests.

## GLOSSARY

**Win Per Day:** The amount of net revenue generated by a single slot machine/VLT in a single day, after all winners have been paid. The statistic is a common industry measure of slot machine/VLT productivity.

**Racinos:** Slot machine/VLT facilities owned and operated by horse racetrack owners, and typically located inside, or adjacent to, the tracks.

**Marketing Allowance:** The amount of money provided by New York State to racino owners in order to assist them in their marketing efforts.

**EBITDA:** Earnings before interest, taxes, depreciation and amortization. Derived from a corporation's income statements, EBITDA is a popular statistic used by financial analysts and corporate valuation experts.

**Slots License:** A slots license is the right to operate a certain number of slot machines at a given location. A slots license does not include the land, building, machines or other tangible assets used in racinos. The term may also be applied to VLT Licenses.

**Purse Subsidy:** Either by law or by agreement with racehorse owners, racinos typically allocate a portion of their slots/VLT win to increasing purses. Racehorse owners who have horses that win, place or show thus receive higher prizes than would otherwise ensue.

## **APPENDIX: THE AD HOC COMMITTEE ON THE FUTURE OF RACING**

In 2005 New York State created the nine-member Ad Hoc Committee on the Future of Racing, with three members to be appointed each by Governor Pataki, Senate Majority Leader Bruno and Assembly Speaker Silver.

Their statutory charge is to issue a formal request for proposals for the exclusive right to operate and maintain the thoroughbred facilities located at Belmont, Aqueduct and Saratoga, taking into account VLT gambling issues, the viability of New York's State's racing industry, and the generation of reasonable revenue for the support of government.

Pataki appointed NYS Parks & Recreation Commissioner Bernadette Castro, Manhattan lawyer Fredric S. Newman and former Avis executive (and former NYS Republican Chairman) J. Patrick Barrett. Bruno appointed Jack Knowlton, a co-owner of 2003 Kentucky Derby and Preakness winner Funny Cide, and Capital District businessmen John Nigro and Edward P. Swyer. As of January 2006, Speaker Silver had yet to make any appointments. Patrick Barrett serves as committee chair.

On January 24-25, 2006 the Ad Hoc Committee held hearings in Albany and New York City to further its mission, focusing on three questions:

- What should the Committee place within any Request for Proposal?
- How should the Committee balance maximization of revenues to the State with maintaining the historical traditions of the industry?
- Should one franchise be awarded for Aqueduct, Belmont and Saratoga or should the franchise be divided among tracks, meets and geographic location?