

*Send to a Colleague*

**Maryland Tax Education Foundation**

**Are the License Fees Too Low?**

**An Independent Analysis of the Profitability of a  
Baltimore Slots Facility that (i) Pays a \$100 Million  
Licensing Fee and (ii) Retains 25% of the “Slots Win”**

**By Jeff Hooke**

**February 11, 2003**

## **Information About MTEF and the Author**

Maryland Tax Education Foundation (MTEF) is a non-partisan, non-profit organization, located at 103 North Adams Street, Rockville, MD 20850-2217 ([www.marylandtaxeducation.org](http://www.marylandtaxeducation.org)). Contributions are tax deductible.

MTEF does not advocate the introduction of slot machines into Maryland. If the State approves slot machines, however, MTEF believes the State should receive the best possible economic deal, whether from racetracks or other third parties.

Jeff Hooke, a Chevy Chase, MD resident, is a director of MTEF. He is an investment banker with 25 years of corporate finance experience. He has written three books on corporate finance, valuation and investments, and he served as an adjunct professor of finance for five years at the University of Maryland Business School. He has an MBA from Wharton. See [www.hookeassociates.com](http://www.hookeassociates.com)

The author would like to thank the following investment bankers for their comments: Peter Gavian (Harvard MBA, '58), Corporate Finance of Washington, and Bill Pearce (University of Virginia MBA, '82), Emerging Markets Partnership. David Curry, an economist, also reviewed the study's conclusions.

With respect to this study or related policy work regarding slot machines in Maryland, neither MTEF nor the author have received contributions or compensation from gambling companies, hotel companies, owners/stockholders of such firms, lobbyists or former owners/stockholders of Maryland racetracks.

## Q&A

### ***Q1. What are the conclusions of MTEF's study?***

- A. The study concludes that the proposed slots monopolies will be highly profitable. Accordingly, the facility can support higher license fees, which are tax deductible.

This study contradicts published reports in which the racetrack owners indicate that under the proposed arrangement, their slots facilities will lose money.

### ***Q2. How much daily win can the Pimlico slots facility expect per slot machine?***

- A. In similar high-population-density areas, such as suburban Chicago and downtown Detroit, the daily win per machine (i.e., the daily profit after payments to bettors) ranges from \$400-\$500 (Detroit) to \$400-\$750 (Chicago). These areas have more competition than Baltimore, suggesting that Baltimore's win should exceed this range per machine per day. This analysis uses \$600 in win per machine per day<sup>1</sup>.

Baltimore will have far fewer slot machines per capita than either Detroit or Chicago. This disparity suggests unfulfilled demand and higher usage (i.e., higher win). For example, a Baltimore area with 12,000 machines might yield \$400 in win per machine per day; if only 3,000 machines were available the win would be much higher. For this reason, the analysis uses \$600 per day.

### ***Q3. How much annual revenue is \$600 in daily win per machine?***

- A. The Pimlico facility can expect \$657 million in annual gross revenues (i.e., 3,000 machines x 365 days x \$600).

The analysis assumes a 25% participation rate for the track in the slots' revenues. In dollar terms, this annual revenue equals \$164 million.

The remaining 75% goes to the State, local governments and purses.

---

<sup>1</sup> Source: Websites of Illinois Gaming Board and Michigan Gaming Control Board. Note that the Chicago Metro area (including Gary, Indiana) has approximately 15,000 slot machines. The Detroit Metropolitan area, including Windsor, Ontario, has approximately 12,500 slot machines. The Baltimore Metro area will have only 3,000 machines.

***Q4. The track owners say the proposed arrangement isn't enough to pay operating expenses. Is that true?***

A. Slot machine facilities are highly automated, and have fewer costs per revenue dollar than many other forms of “entertainment,” such as restaurants, sporting events and motion pictures. Furthermore, this analysis assumes the State of Maryland pays for the slot machines, which represent one of the largest single expense categories.

We estimate annual operating expenses of the Pimlico slots facility to be \$98.6 million, which is 60% of annual revenue of the facility.

Larger casino companies that provide labor-intensive table games (craps, 21 and roulette) and hotel rooms have operating expense to revenue ratios of 70% to 75%.

***Q5. How did MTEF derive this number?***

A. We analyzed the expense margins of Dover Downs Entertainment, excluding its hotel and harness track. We also reviewed the operating expenses of Charlestown Raceway, excluding its horse track and new parking structure. We considered the expense requirements of a number of larger gambling companies<sup>2</sup>. Our conclusions were then applied to the proposed Pimlico facility. By way of example, we project Pimlico’s annual operating expenses to be more than double the operating expenses of Dover Downs. See the attachment.

***Q6. What is the forecasted pre-tax, pre-interest profit then?***

A. Earnings Before Interest and Taxes (i.e., EBIT) equals “net revenue” (\$164.0) minus “operating expenses” (\$98.6), or \$66.4 million per year.

***Q7. How much is the construction cost of a new slot facility?***

A. The new slot facility will require a building of 100,000 square feet. This will be the size of a large Wal-Mart store, but it will require more expensive furniture and fixtures. Dover Downs spent approximately \$31.5 million for its 80,000 square foot facility<sup>3</sup>. This analysis uses \$50 million, or 61% more than Dover Downs’ cost to reflect Baltimore’s more expensive construction environment and larger size<sup>4</sup>.

---

<sup>2</sup> Operating expense data on many gambling companies, including Dover Downs, is available on SEC filings.

<sup>3</sup> See Dover Downs Entertainment’s SEC filings for 2001.

<sup>4</sup> The assumption indicates \$500 per sq. ft. in construction costs, which was verified by two real estate finance executives.

**Q8. *Won't the Baltimore slots facility require a new hotel and new parking lot?***

A. No. Baltimore has thousands of hotel rooms. The Pimlico racetrack has a massive parking lot that is 90% empty for most days of the year. Similarly, Rosecroft and Laurel will not need expensive hotels or parking lots.

Adding a mid-sized hotel of 300 rooms might cost \$50 million to \$60 million. The hotel would generate income, but its return on investment would be less than the pure slots facility.

**Q9. *Won't the slot facility need lots of working capital?***

A. No. Slots are a cash business, like supermarkets, which typically have negative working capital. They receive payment for goods and services from their customers immediately, even though their suppliers wait 15-30 days before receiving payment.

**Q10. *The upfront cost looks like \$100 million for the license and \$50 million for the building. If you include furniture and fixtures of \$10 million and start-up costs of \$10 million, the initial investment is \$170 million. Will the forecast profit cover this investment?***

A. Yes. The facility is profitable from Day One. Its projected return on stockholders' investment is 36.5%. Most publicly-traded companies return 15% or less. U.S. Treasury Bonds yield 4%.

**Q11. *What about the briefing given by the State Department of Legislative Services?***

A. In this particular case, the Legislative Services Department used outdated information, such as a presumed \$217 daily win per machine, which bore little relevance to Maryland's demographics and daily wins in comparable localities.

MTEF's estimate of daily win has been widely distributed in Annapolis since September 2002.

***Q12. How much can former Maryland Jockey Club owners expect to earn from the slot facilities?***

A. A number of the former MJC owners have agreements with Magna Corporation that provide them with a stipulated percentage of the slots facilities' pre-tax income after amortizing the costs of capital investments and license fees. Based on our analysis, a former owner with a 12.5% share of this adjusted pre-tax income would receive approximately \$8 million per year, assuming the former owner's share of the initial investments is borrowed, amortized over 10 years, and deducted from his cash allocation. A number of other individuals, estates and partnerships will also share in the slots income<sup>5</sup>.

***Q13. Will the other slots facilities be equally profitable?***

A. Laurel's results should be slightly below Pimlico's. Due to its proximity to Northern Virginia and Metropolitan Washington, DC, we expect Rosecroft to exceed Pimlico's results.

***Q14. After it is successfully in operation, how much could the Baltimore slots facility be sold for?***

A. If it has the same P/E multiple as Dover Downs Entertainment (symbol – DDE), it would have a value of \$438 million.

---

<sup>5</sup> See Magna SEC filings.

## Methodology and Forecast of Baltimore Slots Facility

### I. Dover Downs Entertainment

- Dover Downs is the only pure slots facility that is publicly-traded; its financial results are audited and informative.
- Its slots facility has 80,000 sq. ft. for 2,000 machines. Gross construction cost, excluding land, was \$31.7 million at December 31, 2001 (\$400 per square foot). Furniture and fixtures were estimated at \$5.8 million. (Note 2002 data includes the new hotel.)
- The State of Delaware pays for the company's slot machines and related repairs.
- Dover Downs receives 49% of the win to cover its costs and profits. (Maryland tracks are projected to receive 25% of the win to recover their costs and profits. While this lower percentage might appear to hurt their prospects, the Maryland slots facilities will enjoy substantially more revenue because of their monopoly status in a highly populated area. Simply put, Maryland tracks will receive a "small percentage of a much bigger pie.")
- After paying all state, local and purse taxes, Dover Downs receives \$125 per machine per day to cover expenses and profits. Pimlico will receive \$150 per machine based on this analysis and have a greater number of machines over which to spread fixed costs.
- Caesar's Palace runs the entire Dover Downs slots business for a management fee. The fee was \$7.5 million in 2001. Operating expenses are paid on top of this fee. About 8% of net win, or 4% of gross win, is what the management fee represents.
- Operating expenses include the State's share of the winnings, payments to slot machine providers and harness purses. These amounts never reach the company, so the company's revenue is substantially overstated. (It's like a retailer including sales taxes.) Profit margin is therefore understated. The following pro forma data makes the appropriate adjustments.

**Table 1:**  
**Dover Downs Entertainment – 2001**  
**Recast Income Statement Before Hotel Opening – Pure Slots Facility**  
(In Millions)

	<u>As Reported in SEC Filings</u>	<u>Adjustments</u>	<u>Pro Forma without Hotel, Betting Taxes and Harness Racing<sup>E</sup></u>
Revenues	\$186.7	(6.6) <sup>A</sup> (92.3) <sup>B</sup>	\$87.8
Expenses:			
Operating	143.2	(92.3) <sup>B</sup> (5.6) <sup>C</sup>	45.3
Depreciation	2.2	--	2.2
Gen. & Admin.	<u>4.7</u>	--	<u>4.7</u>
	150.1		52.2
EBIT	\$36.6 <sup>D</sup>		\$35.6
EBIT Margin	19.6%		40.5%

<sup>A</sup> Eliminate harness racing revenues.

<sup>B</sup> Eliminate betting taxes from gaming revenues and operating expenses.

<sup>C</sup> Assume harness racing expenses at \$5.6 million and eliminate these expenses.

<sup>D</sup> EBIT equals Earnings Before Interest and Taxes.

<sup>E</sup> We used 2001 data because 2002 data includes the new hotel.

## **II. Dover Downs Entertainment – Return on Investment**

From the SEC filing, the pure slots operating investment included \$31.7 million for the slots facility and \$5.8 million for the furniture and fixtures (i.e., we allocated 50% of the company's furniture and fixtures to slots and 50% to harness racing). These are gross figures before depreciation. Working capital is negative since slots are a cash business, like supermarkets, which have negative working capital.

Simple pre-tax return on investment in 2001:

$$\frac{\text{Adjusted EBIT}}{\text{Adjusted Investment}} = \frac{35.6}{31.7} = 112\%$$

The 112% annual return on total investment is extremely high. By way of comparison, the EBIT return for Dupont, the giant chemical concern, is 6%.

### **III. Operating Forecast for a Baltimore Slots Monopoly**

- **Assumed Slots Win Per Day:** As an absolute monopoly in a highly populated area, a Baltimore facility should yield a win of \$600 per day. This figure is slightly higher than actual results in the Chicago and Detroit markets, which have demographic and competitive similarities, because Baltimore will have far fewer machines on a per capita basis.
- **Assumed Annual Revenue:** \$600 per day, with a 75% betting tax, provides net annual revenues to the facility of \$164 million (or \$657 million gross), using a base of 3,000 machines.
- **Assumed EBIT Margin:** Due to its monopoly status, higher revenue base, reduced need for free bus rides, and lack of other costly marketing programs, Baltimore's EBIT margin might be projected higher than Dover Downs; however, higher wages and ancillary expenses in Baltimore might decrease the EBIT margin by the same amount.
- Accordingly, this analysis assume 40.5%, the same EBIT margin as Dover Downs Entertainment as shown in Table 1.
- **Assumed Fixed Investment:** Assume the building investment to be \$50.0 million, for a 100,000 square foot building at \$500 construction cost per square foot (Baltimore will need more space for more machines). Assume furniture and fixture costs of \$10 million. The total fixed investment is \$60 million. (More likely, the slots building could be leased.)
- **Assumed Start-up costs:** Assumed start-up costs are \$10 million, so the total up-front operating investment is \$70 million (\$60 million plus \$10 million). Table 2 provides summary data.

**Table 2:**  
**Baltimore Slots Monopoly –**  
**Operating Forecast**

	<u>(Millions)</u>
Revenue	\$164.0
EBIT	66.4
Upfront Operating Investment	70.0
Upfront License Fee	100.0

#### IV. Pro Forma for Baltimore Monopoly

- Assume \$100 million in upfront license fees and \$70 million combined operating investment and start-up costs.
- Assume \$70 million is borrowed at a junk bond rate of 8%.

**Table 3:**  
**Pro Forma Baltimore Slots Facility**<sup>A</sup>  
(In millions)

<b><u>Income Statement</u></b>	
Revenue	\$164.0
EBIT	66.4
Interest on \$70 million @ 8%	<u>5.6</u>
Pre-tax Income	60.8
Income Taxes @ 40%	<u>(24.3)</u>
Net Income	<u>\$36.5</u>

  

<b><u>Balance Sheet</u></b>	
<u>Assets:</u>	
Building and Fixtures	\$60.0
Start-up Costs	10.0
License Fee	<u>100.0</u>
	\$170.0
<u>Liabilities and Stockholders Equity:</u>	
Debt	\$70.0
Stockholders' Equity	<u>100.0</u>
	\$170.0

<sup>A</sup>The pro forma results assume a single unified corporation that receives 100% of the revenues. In fact, the income from the slots may be divided between Magna and former Jockey Club stockholders, unless various agreements are amended.

- The return on stockholders' equity is 36.5% (36.5/100). This is higher than the vast majority of publicly-traded companies.
- The license fees and start-up costs can be written-off for tax purposes.

At a 12 P/E multiple, which is the Dover Downs' P/E, the Baltimore monopoly would be worth \$438 million. On a \$100 million equity investment, this represents substantial profit. It also implies that the racetracks can pay higher license fees.