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## Consolidation — What Does It Mean?

**Moderator:**
**Paul Estok**, General Counsel and Corporate Secretary, HTA

**Speakers:**
**Gary Sproule,** Chief Operating Officer, Youbet.com, Inc.
**Scott Daruty**, President, TrackNet Media Group
**Joe Santanna**, President and Chairman of the Board, National HBPA

**MR. PAUL ESTOK:** Good Morning. This is one of those deals where I actually get to use a few of the notes for my business law class to make some introductory remarks. First of all I want to thank Wendy and Doug and Steve as well as all the students and the staff of the Race Track Program for inviting me and for putting on another great Symposium on Racing. Having been involved with putting together a few of these shows quite a number of years ago, I can appreciate the effort that goes into putting on a program like this. Second, I would like to just welcome you again to a panel entitled, "Consolidation — What Does it Mean?" And third, I would like to ask you to hold all your questions or comments until all the speakers have finished and then if you do have a question or comment that you go to the microphone and, particularly, that you state your name when you ask a question or give us a comment.

Given the description of the panel that you all find in your program booklets, I guess we're specifically talking about, and what each of the speakers you're about to hear will address, is vertical integration and consolidation. At its simplest, vertical integration refers to the degree to which a business owns or controls its upstream and downstream suppliers and buyers. Vertically integrated companies are united through a hierarchy and share a common owner. Because it can have a significant impact on a business unit's position in its industry with respect to cost, differentiation and other strategic issues, the vertical scope of a firm is an important consideration in modern corporate strategies. Expansion of activities downstream is generally referred to as forward integration. Expansion upstream is referred to as backward integration. And companies that expand both upstream and downstream are referred to as pursuing a balanced vertical integration.

The strategic reasons for opting for a vertical integration strategy have changed over the years. During the 19th century, firms used vertical integration to achieve economies of scale. The biggest firms that started it in the 19th century were the oil companies. During the middle of the 20th century, vertical integration was used to assure a steady supply of vital inputs to companies.

Subsequently, in the late 20th century, competition intensified in most every industry. Corporate restructuring resulted in the reduction in the levels of vertical integration in large corporations.

Vertical disintegration is facilitated by the widespread use of information, of telecommunications technologies. Those seem to support lower transaction costs between market participants. The theory is that a lower transaction cost can be achieved using information and communication technology rather than by vertically integrating. That causes firms to start vertically disintegrate. That effect is commonly called Coase's Law, for anybody who's really interested. It's named after Ronald Coase who won a Nobel Prize for his work studying price in the marketplace and that very effect. So in short, Coase's law says that when the transaction costs are decreasing the size of any particular firm will also decrease.

Two issues you might want to keep in mind as we hear today's presentations are those of costs and control. The cost aspect depends on the cost of marketing transactions between firms versus the cost of administering the same activities internally within a single firm. The second issue is the impact of asset control, which can impact barriers of entry and which can ensure cooperation of key value-adding players.

There are few generally accepted strengths and weaknesses that are cited when you talk about vertical integration and consolidation. On the strength side, vertical integration potentially offers some of the following advantages: Economies of scale can be achieved. Economies of scope can likewise be achieved. Improvements are seen in supply chain coordination. More opportunities to differentiate are provided by means of increased control of inputs. A firm can capture upstream and downstream profit margins. Firms can increase entry barriers to potential competitors. Firms can gain access to downstream distribution channels that otherwise would remain inaccessible. It can facilitate investment in highly specialized assets in which upstream or downstream players may be reluctant to invest. It can lead to expansion of core competencies. It can reduce the threat from powerful suppliers and or powerful customers and it can offer a higher degree of control over the entire value chain.

While some of the benefits of vertical integration can be quite attractive to firms, the drawbacks may negate some of the potential gains. Vertical integration therefore is thought to have the following potential disadvantages: Capacity balancing issues. For example, a firm might need to build excess upstream capacity to ensure that its downstream operations have sufficient supply under all demand conditions. Potentially higher costs due to lower efficiencies resulting from a lack of supplier competition. Decreased flexibility due to previous upstream and downstream investments. Developing core competencies may compromise existing competencies. Increased bureaucratic costs.

While vertical integration may solve one headache, the firm may well be acquiring several others. And load and capacity balancing between the old and new activities may be hard to achieve.

So what sort of factors favor vertical integration? The accepted thinking says that elements in favor of vertical integration include taxes and regulation on market transactions. Obstacles to the formation and monitoring of contracts. Strategic similarities between vertically integrated activities. The ability to benefit from economies of scale and the reluctance of other firms to make investments specific to the industry.

Factors weighing against vertical integration include the quantity required from a supplier being much less than the minimum efficient scale for producing the product. The product being widely available and its production cost therefore decreasing significantly as cumulative quantity increases. The core competencies between the activities being very different and the vertically adjacent activities being in very different types of industries.

All right, having given you a brief overview of vertical integration, we can now move on to the speakers on the panel. Each of these gentlemen will address this basic topic in his own way and from his own perspective. Let me also remind you that you can find a brief biography of each of the speakers in your Symposium program booklets.

Our first speaker, Scott Daruty, is president of TrackNet Media Group. Scott?

**MR. SCOTT DARUTY:** Good morning. As the introduction just mentioned, I'm Scott Daruty and I'm president of TrackNet Media Group which is a joint venture, as many of you know, owned half by Churchill Downs and half by Magna Entertainment. Prior to joining TrackNet, I was an executive for many years with Magna Entertainment as it pursued its strategy first of horizontal integration through the acquisition of racetracks and then vertical integration as it moved into other lines of business. I think that experience has provided me with certain insight into the topic of vertical consolidation from the racetrack company's perspective. At the same time, I think it's important to note that I do not presently today work directly for either Magna or Churchill and the comments I'm making are my comments, I'm not speaking formally on behalf of either of those companies. I make that point because later in my remarks, as I identify what I see to be some logical opportunities for vertical consolidation in the industry, I don't want anybody to leave this meeting with the impression that that means Magna or Churchill will or won't pursue any particular strategy.

I think that at the outset I'd like to mention some previous examples of vertical consolidation. I think once we get those examples out on the table, it will provide us with some context for the rest of the discussion. I believe one of the earliest forms of vertical consolidation or integration that took place in the racing industry was when racetracks expanded into the off-track betting segment of our business. Now, most people, myself included, typically think of off-track betting as more of a horizontal movement of the racing industry and not so much vertical, but you don't have to look any further than New York to see a market where the off-track betting is operated completely separate and distinct from the racetracks. And when you look at it that way you realize that the expansion into OTBs really was a form of vertical consolidation by the racetracks, it was moving into a new line of business and touching our customers in a new and different way.

From there, coming to more recent times, obviously account wagering is one prime example of vertical integration. Both Magna and Churchill are in the account wagering business as are many other racetrack operators throughout the country. Television, Magna invested and created HRTV a number of years ago. And more recently, Churchill Downs purchased a 50 percent interest in that company, so that's another example of previous vertical consolidation. Magna, a couple of years ago, went out and purchased an interest and finally a controlling interest in AmTote. So they have expanded into the tote business. Churchill on the other hand, recently acquired the BRIS business and so they are now in the wagering data business. Those are all examples, not an exhaustive list, but some key vertical integration has taken place in our industry in the recent past.

So with those examples on the table, what are the driving forces behind that vertical consolidation that's been taking place? In my opinion, there are three primary driving forces. The first one was a strong desire and in fact need on the part of the racetracks to gain better control over their product and the way in which it's distributed and presented to the ultimate betting customer. As technology grew, as wagers moved online, there was a feeling by the racetracks that as more and more of our business expanded into that area, we were very much at the mercy of third parties who were providing this service to the industry, third parties whose interests may or may not be necessarily aligned with that of the underlying racetrack. That said, as Magna and Churchill began to expand into, for example, account wagering, it's never been our position that third parties should not be able to participate in that line of business. In fact, we think that's important, that's healthy, that's something that is good for the industry, that there are third parties participating in these various lines of business. What we do not believe is appropriate is that they be the only parties in the line of business such that they are not merely participating but are actually dictating to the racetracks the manner in which that business is going to be conducted and terms upon which it's going to be conducted.

Let me give you a couple of examples, again, in the account wagering context. Traditionally, account wagering companies paid two to three, sometimes three and a half percent host fees for the live racing product. The racetracks, and I know some horsemen as well, felt that wasn't appropriate, that that model needed to be changed and the host fees derived from account wagering needed to be higher. Well, I believe because of Magna's and Churchill's and other racetracks' participation in account wagering business and because they were both on the racetrack side pushing for higher host fees and also on the account wagering companies side expressing a willingness and a desire to pay higher host fees, that helped bring about some recent change where we're starting to see some upward pressure on the host fees. Now, by saying that, I don't mean to, by any stretch claim full responsibility for that, there have been many people working on that, horsemen, regulators, its been an important issue for the industry, but I think the vertical consolidation that took place, I think was a helpful factor in bringing about some of that change.

Another example, you know sometimes we get so caught up in negotiations within various segments of our industry that we forget for a moment about the real customer out there, the betting public. I think the vertical consolidation integration can actually be good for customers as well. A small example of that is the fact that traditionally the large, third party, domestic account wagering companies charge various fees to their betting customers, be it a 25 or 50-cent per wager transaction fee or a X-dollar a month account maintenance fee, and those might be healthy and good things for third party account wagering companies, but as you've noticed the racetrack companies getting into the account wagering business, you notice that, Magna's account wagering platform, Churchill's account wagering platform, they don't charge those sorts of fees. There might be a certain fee here or there for certain extra services, but the basic service is provided free of charge to the customers. That, again, might not be the best thing economically when you're running an ADW company, but certainly for the racetracks it's a better way of presenting our product ultimately to the betting customer.

So that's, I think, a few points on the first factor, the first driving force behind vertical consolidation.

The second driving force, in my opinion, behind this vertical consolidation has been a need and a desire by the racetracks to maintain better relationships, better contacts with the betting public, with their ultimate customer. You have to remember, too, when we talk about the customers of racetracks, we're not just talking about the betting public, because they are obviously important and the first and foremost customer of the racetracks, but also guest sites are the ultimate purchasers of our product. They are the ones that are paying us the host fees, they're the ones that we sit down and sell the signals to, so they in some respect are our customers as well. And by integrating into various lines of business, we've been able to better maintain our relationship both with the betting customers and with the wagering sites. …….**Other terms, concepts and keywords contained in the balance of this transcript are:** off-track betting, online wagering, live racing, international distribution, settlement business, rebate, Joe Santanna, subsidiary companies, Interstate Horseracing Act, customer-based approach, Gary Sproule, ADW, new customers, distribution channels, open content, exclusivity, consolidation, diversification, integration, competitive advantage, Bruen Productions……..If you desire a full transcript contact bprewitt@ag.arizona.edu