CHURCHILL DOWNS INC
Form 10-Q
November 03, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission file number 001-33998

(Exact name of registrant as specified in its charter)

Kentucky	**61-0156015**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
700 Central Avenue, Louisville, Kentucky 40208	**(502) 636-4400**
(Address of principal executive offices) (zip code)	**(Registrant s telephone number, including area code)**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	Smaller reporting company ¨

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of shares outstanding of registrant s common stock at October 28, 2010 was 16,577,599 shares.

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CHURCHILL DOWNS INCORPORATED

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For the Quarter Ended September 30, 2010

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CHURCHILL DOWNS INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited) (in thousands)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 14,533	$ 13,643
Restricted cash	61,101	35,125
Accounts receivable, net of allowance for doubtful accounts of $3,195 in 2010 and $1,024 in 2009	22,472	33,446
Deferred income taxes	8,231	6,408
Other current assets	19,555	16,003
Total current assets	125,892	104,625
Property and equipment, net	465,922	458,222
Goodwill	183,394	115,349
Deferred income taxes	5,373	
Other intangible assets, net	56,842	34,329
Other assets	12,508	12,877
Total assets	$ 849,931	$ 725,402
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 38,149	$ 35,034
Bank overdraft	10,667	3,738
Purses payable	16,223	11,857
Accrued expenses	52,384	46,603
Liabilities associated with assets held for dissolution	1,089	
Dividends payable		6,777
Deferred revenue	17,597	30,972
Income taxes payable	501	1,997
Deferred riverboat subsidy	38,613	23,965
Note payable, related party		24,043
Total current liabilities	175,223	184,986
Long-term debt	109,500	71,132
Convertible note payable, related party	14,970	14,655
Other liabilities	20,147	19,137
Deferred revenue	15,532	16,720
Deferred income taxes		11,750
Total liabilities	335,372	318,380

Commitments and contingencies				
Shareholders equity:				
Preferred stock, no par value; 250 shares authorized; no shares issued				
Common stock, no par value; 50,000 shares authorized; 16,577 shares issued September 30, 2010 and 13,684 shares issued December 31, 2009		234,712		145,423
Retained earnings		279,847		261,599
Total shareholders equity		514,559		407,022
Total liabilities and shareholders equity	$	849,931	$	725,402

The accompanying notes are an integral part of the condensed consolidated financial statements.

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CHURCHILL DOWNS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF NET (LOSS) EARNINGS

for the three and nine months ended September 30,

(Unaudited)

(in thousands, except per common share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Net revenues	$ 135,744	$ 100,896	$ 411,306	$ 354,670
Operating expenses	117,168	85,344	331,533	272,556
Selling, general and administrative expenses	15,281	13,092	43,937	37,527
Operating income	3,295	2,460	35,836	44,587
Other income (expense):				
Interest income	30	393	158	780
Interest expense	(1,625)	(245)	(4,303)	(772)
Equity in loss of unconsolidated investments	(470)	(568)	(317)	(641)
Miscellaneous, net	1,832	322	2,485	1,042
	(233)	(98)	(1,977)	409
Earnings from continuing operations before provision for income taxes	3,062	2,362	33,859	44,996
Income tax benefit (provision)	638	(3,578)	(10,034)	(20,423)
Earnings (loss) from continuing operations	3,700	(1,216)	23,825	24,573
Discontinued operations, net of income taxes:				
Loss from operations	(4,389)	(1,109)	(5,577)	(863)
Net (loss) earnings	$ (689)	$ (2,325)	$ 18,248	$ 23,710
Net (loss) earnings per common share data:				
Basic				
Earnings (loss) from continuing operations	$ 0.22	$ (0.09)	$ 1.56	$ 1.75
Discontinued operations	(0.26)	(0.08)	(0.36)	(0.06)
Net earnings (loss)	$ (0.04)	$ (0.17)	$ 1.20	$ 1.69
Diluted				
Earnings (loss) from continuing operations	$ 0.22	$ (0.09)	$ 1.56	$ 1.75
Discontinued operations	(0.26)	(0.08)	(0.36)	(0.06)
Net earnings (loss)	$ (0.04)	$ (0.17)	$ 1.20	$ 1.69
Weighted average shares outstanding				
Basic	16,311	13,587	14,796	13,578

Diluted	16,768	13,587	15,257	14,040

The accompanying notes are an integral part of the condensed consolidated financial statements.

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CHURCHILL DOWNS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

for the nine months ended September 30,

(Unaudited) (in thousands)

	2010	2009
Cash flows from operating activities:		
Net earnings	$ 18,248	$ 23,710
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	34,410	22,399
Asset impairment loss	1,598	
Equity in loss of unconsolidated investments	317	641
Unrealized gain on derivative instruments	(612)	(612)
Share-based compensation	2,388	2,338
Other	1,192	458
Increase (decrease) in cash resulting from changes in operating assets and liabilities, net of business acquisitions:		
Restricted cash	(20,395)	(22)
Accounts receivable	2,099	(2,657)
Other current assets	(1,549)	(394)
Accounts payable	(6,656)	(6,231)
Purses payable	4,367	4,172
Accrued expenses	7,250	4,848
Deferred revenue	11,423	(3,253)
Income taxes payable	(554)	23,273
Other assets and liabilities	1,815	(5,801)
Net cash provided by operating activities	55,341	62,869
Cash flows from investing activities:		
Additions to property and equipment	(56,493)	(32,305)
Contingency payment for acquisition of business		(3,500)
Acquisition of business, net of cash acquired	(32,408)	
Purchases of minority investments	(400)	(1,894)
Acquisition of gaming license	(2,750)	(3,250)
Proceeds on sale of property and equipment	16	8
Change in deposit wagering asset	(37)	307
Net cash used in investing activities	(92,072)	(40,634)
Cash flows from financing activities:		
Borrowings on bank line of credit	204,260	253,314
Repayments on bank line of credit	(141,849)	(263,454)
Repayment of note payable, related party	(24,043)	
Change in book overdraft	6,929	(2,041)
Payment of dividends	(6,777)	(6,767)
Repurchase of common stock	(1,354)	(89)
Common stock issued	459	427
Change in deposit wagering liability	(4)	269

Net cash provided by (used in) financing activities	37,621	(18,341)
Net increase in cash and cash equivalents	890	3,894
Cash and cash equivalents, beginning of period	13,643	12,658
Cash and cash equivalents, end of period	$ 14,533	$ 16,552

The accompanying notes are an integral part of the condensed consolidated financial statements.

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CHURCHILL DOWNS INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

for the nine months ended September 30,

(Unaudited) (in thousands)

	2010	2009
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 2,706	$ 302
Income taxes	$ 7,014	$ 6,829
Schedule of non-cash investing and financing activities:		
Issuance of common stock in connection with acquisition of business	$ 86,497	$
Issuance of common stock in connection with LTIP and restricted stock plans	$ 2,525	$

The accompanying notes are an integral part of the condensed consolidated financial statements.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

The accompanying Condensed Consolidated Financial Statements are presented in accordance with the requirements of this Quarterly Report on Form 10-Q and consequently do not include all of the disclosures required by accounting principles generally accepted in the United States of America or those normally made in Churchill Downs Incorporated s (the Company) Annual Report on Form 10-K. The year-end Condensed Consolidated Balance Sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. Accordingly, the reader of this Quarterly Report on Form 10-Q should refer to the Company s Annual Report on Form 10-K for the year ended December 31, 2009 for further information. The accompanying Condensed Consolidated Financial Statements have been prepared in accordance with the Company s customary accounting practices and have not been audited.

In the opinion of management, all adjustments necessary for a fair statement of this information have been made, and all such adjustments are of a normal, recurring nature.

The Company s revenues and earnings are significantly influenced by its racing calendar. Therefore, revenues and operating results for any interim quarter are generally not indicative of the revenues and operating results for the year and may not be comparable with results for the corresponding period of the previous year. The Company conducts the majority of its live racing during the second, third and fourth quarters, including the running of the Kentucky Derby and the Kentucky Oaks during the second quarter, the quarter during which the Company typically generates the majority of its annual operating income. The Company conducted 111 live racing days during the third quarter of 2010, which compares to 118 live racing days conducted during the third quarter of 2009. For the nine months ended September 30, 2010, the Company conducted 278 live racing days, which compares to 297 live racing days conducted during the nine months ended September 30, 2009.

Comprehensive Earnings

The Company had no other components of comprehensive earnings and, as such, comprehensive earnings is the same as net earnings as presented in the accompanying Condensed Consolidated Statements of Net Earnings.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 2 DISCONTINUED OPERATIONS

During September 2010, the Company committed to a plan to dissolve Churchill Downs Entertainment Group, (CDE), an entity created to conceive and produce large-scale entertainment events. The decision was made to dissolve the group because of our belief that achieving financial success conducting large-scale entertainment events is very difficult in the current economy.

Financial Information

CDE, Ellis Park and Hollywood Park have been accounted for as discontinued operations. Accordingly, the results of operations of the dissolved and sold businesses for all periods presented have been classified as discontinued operations, net of income taxes, in the Condensed Consolidated Statements of Net (Loss) Earnings. Set forth below is a summary of the results of operations of the dissolved and sold businesses for the three and nine months ended September 30, 2010 and 2009 (in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net revenues	$ 6,303	$	$ 6,303	$
Operating expenses	11,921		12,793	
Selling, general and administrative expenses	1,389		2,060	
Operating loss	(7,007)		(8,550)	
Other income (expense):				
Miscellaneous, net		(46)	69	362
		(46)	69	362
(Loss) earnings from continuing operations before income tax benefit (provision)	(7,007)	(46)	(8,481)	362
Income tax benefit (provision)	2,618	(1,063)	2,904	(1,225)
Net loss	$ (4,389)	$ (1,109)	$ (5,577)	$ (863)

Set forth below is a summary of the net assets held for dissolution, which relate to CDE, as of September 30, 2010 (in thousands):

	September 30, 2010
Assets held for dissolution	$
Current liabilities:	
Accrued severance expense	760
Other accrued expenses	329
Liabilities associated with assets held for dissolution	$ 1,089

NOTE 3 HOOSIER PARK CONSIDERATION

In accordance with the sale of the Company s 62% ownership interest in Hoosier Park, L.P. (Hoosier Park) to Centaur Racing, LLC (Centaur), on March 30, 2007, the Company received a promissory note issued, jointly and severally, by three individual investors in Centaur (the Note) in the amount of $4.0 million, which accrued interest at a rate of 8.25% per year. According to the terms of the Note, interest was due and payable in one lump sum upon maturity of the note on March 30, 2010. As of September 30, 2010, approximately $5.1 million of principal and interest is outstanding in accordance with the Note terms. The Company has determined that the amount outstanding is collectible and that no allowance is deemed necessary as of September 30, 2010.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The Partnership Interest Purchase Agreement with Centaur includes a contingent consideration provision whereby the Company is entitled to payments of up to $15 million on the date which is eighteen months after the date that slot machines are operational at Hoosier Park. During June 2008, Hoosier Park commenced its slot operations, fulfilling the terms of the contingency provision. As of September 30, 2010, the Company has determined that collectability of amounts due under the contingent consideration provision is not reasonably assured and, therefore, has not recognized the amounts due under the Partnership Interest Purchase Agreement. Amounts due will be recorded as a gain on the sale of Hoosier Park once collectability is reasonably assured.

NOTE 4 ACQUISITIONS

Harlow s Casino Resort & Hotel Acquisition

During September 2010, the Company announced that it had entered into a definitive purchase agreement to acquire Harlow s Casino Resort & Hotel in Greenville, Mississippi in a transaction valued at approximately $138.0 million. The Company expects to finance the purchase price with borrowings under its revolving credit facility. The transaction is subject to receipt of all required regulatory approvals, including securing a gaming license in Mississippi, obtaining approval from its lenders under the revolving credit facility and other customary closing conditions. Closing is expected to occur during the fourth quarter of 2010 or the first quarter of 2011.

Youbet Acquisition

On June 2, 2010, the Company completed its acquisition of Youbet.com, Inc. (Youbet) pursuant to an Agreement and Plan of Merger dated as of November 11, 2009 for an aggregate purchase price of $131.8 million, which consisted of $45.3 million of cash and approximately 2.7 million shares of the Company s common stock valued at $86.5 million based on the closing price of the Company s common stock on June 1, 2010 of $32.04. The transaction included the acquisition of the account wagering platform of Youbet and the operations of United Tote Company and United Tote Canada (collectively United Tote), which manufactures and operates pari-mutuel wagering systems for approximately 100 racetracks, off-track betting facilities (OTBs) and other pari-mutuel wagering businesses. The primary reason for the acquisition was to invest in assets with an expected yield on investment and continue the Company s growth in one of the fastest growing segments of the pari-mutuel industry.

The acquisition of Youbet was accounted for under the purchase method. The following table summarizes the preliminary estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition. Such estimates are subject to refinement as additional valuation information is received.

	Total
Restricted cash	$ 5,544
Accounts receivable, net	2,761
Prepaid expenses	984
Inventory	1,020
Other assets	103
Property and equipment	9,063
Deferred income taxes	30,663
Goodwill	68,045
Other intangible assets	27,300
Total assets acquired	145,483
Accounts payable	11,140

Accrued expenses	4,609
Deferred revenue	299
Income taxes payable	(941)
Deferred income taxes	11,471
Total liabilities acquired	26,578
Purchase price, net of cash acquired	$ 118,905

Depreciation of property and equipment acquired is calculated using the straight-line method over the estimated useful lives of the related assets as follows: 3 to 5 years for computer hardware and software, 5 to 10 years for equipment, 7 years for

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

furniture and fixtures and 1 to 7 years for leasehold improvements. Amortization of other intangible assets acquired is calculated using the straight-line method over the estimated useful life of the related intangible asset. Other intangible assets primarily consist of three segments of customer relationships valued at $15.1 million, $4.6 million and $7.0 million with lives of 7 years, 6 years and 5 years, respectively. The entire balance of goodwill, which includes expected synergies from combining the operations of Youbet and the Company, has been allocated to the Online Business segment. The Company does not expect to deduct any portion of goodwill for income tax purposes.

During the nine months ended September 30, 2010, the Company recognized an impairment loss of $1.3 million associated with software owned by TwinSpires. The Company determined such software would not be utilized as a result of a reassessment of the use of certain technology in connection with its acquisition of Youbet.

On September 28 and 29, 2010, the Company provided notices to 36 employees that their employment will likely be terminated effective on or around December 3, 2010. The Company also informed 23 other employees that their employment will likely be terminated between December 31, 2010 and January 31, 2011, and informed 5 employees that their employment will likely be terminated during the period of 3 to 12 months after December 31, 2010. Certain of these employees have already received or may receive offers to relocate to another division of the Company at one of the Company s other facilities.

These employee separations were prompted by the identification of redundancies in the Company s Online Business as a result of the Company s merger with Youbet, which was completed on June 2, 2010, and this action is one of the Company s undertakings to achieve the $12 million in anticipated annualized cost synergies in connection with the Company s acquisition and integration of Youbet, as previously disclosed. During the three months ended September 30, 2010, in accordance with the terms of a historic, ongoing benefit arrangement, the Company recognized $1.2 million of severance and other benefits costs, which are included within selling, general and administrative expenses in the Condensed Consolidated Statement of Net (Loss) Earnings.

<u>Pro Forma</u>

The following table illustrates the effect on net revenues, earnings from continuing operations and earnings from continuing operations per common share as if the Company had consummated the merger with Youbet as of the beginning of each period presented. The pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations that would have occurred had the merger with Youbet been consummated at the beginning of the respective periods.

	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net revenues	$ 128,772	$ 457,724	$ 440,777
Earnings from continuing operations	(627)	22,362	27,787
Earnings from continuing operations per common share			
Basic:			
Earnings from continuing operations	$ (0.04)	$ 1.33	$ 1.66
Diluted:			
Earnings from continuing operations	$ (0.04)	$ 1.33	$ 1.66
Shares used in computing earnings from continuing operations per common share:			
Basic	16,287	16,309	16,278
Diluted	16,287	16,770	16,740

During the three months ended September 30, 2010, Youbet and United Tote contributed total revenues of $25.3 million and earnings before income tax provision of $0.4 million, to the Company s reported results included in the Condensed Consolidated Statement of Net Earnings. During the nine months ended September 30, 2010, Youbet and United Tote contributed total revenues of $34.0 million and earnings before income tax provision of $0.4 million, to the Company s reported results included in the Condensed Consolidated Statement of Net Earnings.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 5 SETTLEMENT WITH ODS

On July 2, 2010, the Company entered into an agreement with ODS Technologies, LP (d/b/a TVG) (ODS), settling a dispute arising under the License and Content Agreement dated as of May 18, 2001, as subsequently amended and modified, between TVG and ODS (the Agreement). As part of the settlement, the Agreement was terminated and the Company received a one-time, payment of $1.3 million, which was recognized as miscellaneous income during the third quarter of 2010.

NOTE 6 INCOME TAXES

The Company recently underwent a federal income tax audit for calendar years 2004 through 2008.

During 2005 and 2006, the Company received approximately $23.5 million of proceeds related to the sale of Personal Seat Licenses (PSLs) sold in connection with the renovation of Churchill Downs Racetrack (Churchill Downs). The PSLs that were sold included those with terms of 30 years and 5 years and provided the purchaser the right to purchase tickets to the Kentucky Derby, Kentucky Oaks and Breeders Cup races each year during the term of the license. Accordingly, for tax purposes, the Company deferred the income for the PSLs over the respective terms of the licenses.

During 2009, the Internal Revenue Service (the IRS) proposed that the income related to the sale of the PSLs is taxable during the period the proceeds were received by the Company (the Proposed Audit Adjustment). As a result, the Proposed Audit Adjustment served to increase the amount of income taxes due for each of the tax years 2005 and 2006.

On April 14, 2010, the Company defended its position of deferring income related to the sale of PSLs using a fast track mediation process offered by the IRS. During the fast track mediation process, the Company agreed to change its method of accounting for proceeds related to the sale of PSLs to the deferral method provided for in Revenue Procedure 2004-34, effective for the taxable year ended December 31, 2007. As a result, the Company s taxable income for each of the years ended December 31, 2007 and 2008 will increase by $19.1 million and $0.4 million, respectively. In accordance with the settlement entered into during the fast track mediation process, the Company recognized an income tax benefit from continuing operations of $1.6 million during the nine months ended September 30, 2010 reflecting a reduction of interest expense previously estimated and recognized during 2009 as a result of the Proposed Audit Adjustment.

As of September 30, 2010, the Company had gross unrecognized income tax benefits of $2.3 million. Additionally, the Company recognized income tax benefits related to uncertain tax positions of $0.2 million for each of the three and nine months ended September 30, 2010. The Company anticipates a decrease in its unrecognized income tax benefits of approximately $0.5 million over the next twelve months. The anticipated decrease is primarily due to the expiration of statutes in various jurisdictions.

The Company recognizes accrued interest related to unrecognized income tax benefits in income tax expense and penalties in selling, general and administrative expenses in the Condensed Consolidated Statements of Net (Loss) Earnings. As of September 30, 2010, the Company had accrued $0.2 million of interest related to unrecognized income tax benefits.

The timing of any payments for any related state tax deficiencies will generally follow closely after the timing of any federal payments.

NOTE 7 GOODWILL AND INDEFINITE-LIVED INTANGIBLE ASSETS IMPAIRMENT TEST

Goodwill and indefinite-lived intangible assets are tested for impairment on an annual basis. In assessing whether goodwill is impaired, the fair value of the related reporting unit is compared to its carrying amount, including goodwill. If the carrying amount of the reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. The second step of the goodwill impairment test consists of comparing the implied fair value of reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized equal to such excess. The implied fair value of goodwill is determined in the same manner as when determining the amount of goodwill recognized in a business combination. The Company completed the required annual impairment tests of goodwill and indefinite-lived intangible assets during the three months ended March 31, 2010, and no adjustment to the carrying value of goodwill or indefinite-lived intangible assets was required.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 8 FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company adheres to a hierarchy for ranking the quality and reliability of the information used to determine fair values. Assets and liabilities that are carried at fair value are classified and disclosed in one of the following three categories:

Level 1: Unadjusted quoted market prices in active markets for identical assets or liabilities.

Level 2: Unadjusted quoted prices in active markets for similar assets or liabilities, unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.

Level 3: Unobservable inputs for the asset or liability.

In January 2010, the Financial Accounting Standards Board (FASB) issued authoritative guidance on improving disclosures about fair value measurements. This guidance requires new disclosures about transfers in and out of Level 1 and 2 measurements and separate disclosures about activity relating to Level 3 measurements. In addition, this guidance clarifies existing fair value disclosures about the level of disaggregation and the input and valuation techniques used to measure fair value. The guidance only relates to disclosure and does not impact the Company s condensed consolidated financial statements. The Company adopted this guidance during the first quarter of 2010. There was no significant impact to the Company s disclosures upon adoption.

The Company endeavors to utilize the best available information in measuring fair value. Financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. Approximately $2.5 million of the Company s cash equivalents and restricted cash as of September 30, 2010, which are held in interest bearing accounts, are recorded based on Level 1 inputs. The Company currently has no other assets or liabilities subject to fair value measurement on a recurring basis.

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash Equivalents The carrying amount reported in the balance sheet for cash equivalents approximates its fair value due to the short-term maturity of these instruments.

Long-term Debt The carrying amounts of the Company s borrowings under its line of credit agreements and other long-term debt approximates fair value, based upon current interest rates.

Convertible Note Payable, Related Party The fair value of the convertible note payable, related party and the related embedded derivative instruments are estimated using pricing models similar to those used to value stock options. The Company determined it was not practicable to estimate the fair value of the Convertible Note Payable, related party, as a quoted market price is not available and the cost of obtaining an independent valuation is excessive. The principal amount of the Convertible Note Payable, related party, is $16.7 million, and it matures on October 18, 2014.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 9 EARNINGS PER COMMON SHARE COMPUTATIONS

The following is a reconciliation of the numerator and denominator of the earnings per common share computations (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Numerator for basic earnings (loss) from continuing operations per common share:				
Earnings (loss) from continuing operations	$ 3,700	$ (1,216)	$ 23,825	$ 24,573
Earnings (loss) from continuing operations allocated to participating securities	(100)		(707)	(793)
Numerator for basic earnings (loss) from continuing operations per common share	$ 3,600	$ (1,216)	$ 23,118	$ 23,780
Numerator for basic net (loss) earnings per common share:				
Net (loss) earnings	$ (689)	$ (2,325)	$ 18,248	$ 23,710
Net loss allocated to participating securities			(542)	(765)
Numerator for basic net (loss) earnings per common share	$ (689)	$ (2,325)	$ 17,706	$ 22,945
Numerator for diluted net (loss) earnings per common share:				
Earnings (loss) from continuing operations	$ 3,700	$ (1,216)	$ 23,825	$ 24,573
Discontinued operations, net of income taxes	(4,389)	(1,109)	(5,577)	(863)
Net (loss) earnings	$ (689)	$ (2,325)	$ 18,248	$ 23,710
Denominator for net (loss) earnings per common share:				
Basic	16,311	13,587	14,796	13,578
Plus dilutive effect of stock options	4		8	9
Plus dilutive effect of convertible note	453		453	453
Diluted	16,768	13,587	15,257	14,040
(Loss) earnings per common share:				
Basic				
Earnings (loss) from continuing operations	$ 0.22	$ (0.09)	$ 1.56	$ 1.75
Discontinued operations	(0.26)	(0.08)	(0.36)	(0.06)
Net (loss) earnings	$ (0.04)	$ (0.17)	$ 1.20	$ 1.69
Diluted				
Earnings (loss) from continuing operations	$ 0.22	$ (0.09)	$ 1.56	$ 1.75
Discontinued operations	(0.26)	(0.08)	(0.36)	(0.06)

Net (loss) earnings	$ (0.04)	$ (0.17)	$ 1.20	$ 1.69

Options to purchase approximately 191 thousand shares and 137 thousand shares for the three and nine months ended September 30, 2010 are excluded from the computation of earnings from continuing operations per common share assuming dilution because the options exercise prices were greater than the average market price of the common shares.

Options to purchase approximately 112 thousand shares for the nine months ended September 30, 2009 are excluded from the computation of earnings from continuing operations per common share assuming dilution because the options exercise prices were greater than the average market price of the common shares. Options to purchase approximately eight thousand shares for the three months ended September 30, 2009 are excluded from the computation of diluted net loss from continuing operations per common share since their effect is antidilutive because of the net loss from continuing operations for the period. Also, 453 thousand shares issuable upon conversion of notes payable for the three months ended September 30, 2009 are excluded from the computation of diluted net loss from continuing operations per common share since their effect is antidilutive because of the net loss for the period.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 10 SEGMENT INFORMATION

The Company operates in the following four segments: (1) Racing Operations, which includes Churchill Downs, Calder Race Course, Arlington Park Race Course and its ten OTBs and Fair Grounds Race Course and the pari-mutuel activity generated at its eleven OTBs; (2) Online Business, which includes TwinSpires, our Advance Deposit Wagering (ADW) business, Youbet.com, LLC, an ADW business acquired on June 2, 2010, and Bloodstock Research Information Services, as well as the Company s equity investment in HRTV, LLC; (3) Gaming, which includes video poker and gaming operations at Fair Grounds Slots and Calder Casino and Video Services, Inc., an owner and operator of more than 800 video poker machines in Louisiana; and (4) Other Investments, which includes United Tote, a manufacturer and operator of pari-mutuel wagering systems acquired by the Company on June 2, 2010, Churchill Downs Simulcast Productions and the Company s other minor investments. Eliminations include the elimination of intersegment transactions.

The accounting policies of the segments are the same as those described in the Summary of Significant Accounting Policies in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The Company uses revenues and EBITDA (defined as earnings before interest, taxes, depreciation and amortization) as key performance measures of the results of operations for purposes of evaluating performance internally. Furthermore, management believes that the use of these measures enables management and investors to evaluate and compare from period to period the Company s operating performance in a meaningful and consistent manner. Because the Company uses EBITDA as a key performance measure of financial performance, the Company provides a reconciliation of its calculation of EBITDA to net earnings. However, these measures should not be considered as an alternative to, or more meaningful than, net earnings (as determined in accordance with accounting principles generally accepted in the United States of America) as a measure of the Company s operating results or cash flows (as determined in accordance with accounting principles generally accepted in the United States of America) as a measure of the Company s liquidity.

EBITDA of the corporate segment includes approximately $0.5 million of management fees for the three and nine months ended September 30, 2010 related to the dissolution of CDE which is included in discontinued operations.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The table below presents information about reported segments for the three and nine months ended September 30, 2010 and 2009 (in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Net revenues from external customers:				
Churchill Downs	$ 5,449	$ 5,226	$ 96,979	$ 95,718
Arlington Park	29,445	33,935	61,533	75,337
Calder	21,604	22,663	42,848	44,295
Fair Grounds	5,942	6,534	32,367	35,262
Total Racing Operations	62,440	68,358	233,727	250,612
Online Business	38,739	17,386	86,089	54,830
Gaming	28,306	14,104	82,824	47,368
Other Investments	6,195	963	8,599	1,320
Corporate	64	85	67	540
Net revenues from external customers	$ 135,744	$ 100,896	$ 411,306	$ 354,670
Intercompany net revenues:				
Churchill Downs	$ 336	$ 233	$ 2,872	$ 2,438
Arlington Park	1,199	800	2,542	1,637
Calder	557	381	932	743
Fair Grounds	39	11	586	591
Total Racing Operations	2,131	1,425	6,932	5,409
Online Business	112	150	533	448
Other Investments	629	386	1,604	1,286
Eliminations	(2,872)	(1,961)	(9,069)	(7,143)
Net revenues	$	$	$	$
Reconciliation of Segment EBITDA to net (loss) earnings:				
Racing Operations	$ 1,254	$ 3,428	$ 37,819	$ 41,174
Online Business	5,818	2,802	14,467	11,767
Gaming	7,892	3,884	19,537	15,401
Other Investments	1,792	831	2,918	1,651
Corporate	296	(1,208)	(2,327)	(2,606)
Total EBITDA	17,052	9,737	72,414	67,387
Depreciation and amortization	(12,395)	(7,523)	(34,410)	(22,399)
Interest (expense) income, net	(1,595)	148	(4,145)	8
Income tax benefit (provision)	638	(3,578)	(10,034)	(20,423)
Earnings (loss) from continuing operations	3,700	(1,216)	23,825	24,573

Discontinued operations, net of income taxes	(4,389)	(1,109)	(5,577)	(863)
Net (loss) earnings	$ (689)	$ (2,325)	$ 18,248	$ 23,710

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The table below presents information about equity in earnings and losses of unconsolidated investments included in the Company s reported segments for the three and nine months ended September 30, 2010 and 2009 (in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Online Business	$ (543)	$ (490)	$ (345)	$ (536)
Other Investments	73	(78)	28	(105)
	$ (470)	$ (568)	$ (317)	$ (641)

The table below presents total asset information for reported segments (in thousands):

	September 30, 2010	December 31, 2009
Total assets:		
Racing Operations	$ 779,390	$ 645,933
Online Business	197,291	88,664
Gaming	110,316	107,128
Other Investments	190,124	178,707
	1,277,121	1,020,432
Eliminations	(427,190)	(295,030)
	$ 849,931	$ 725,402

The table below presents total goodwill information for reported segments (in thousands):

	September 30, 2010	December 31, 2009
Goodwill:		
Racing Operations	$ 50,401	$ 50,401
Online Business	128,608	60,563
Gaming	3,127	3,127
Other Investments	1,258	1,258
	$ 183,394	$ 115,349

The table below presents total capital expenditure information for reported segments (in thousands):

	Nine Months Ended September 30, 2010	2009
Capital expenditures, net:		
Racing Operations	$ 33,825	$ 6,497
Online Business	3,842	1,578
Gaming	16,667	23,102
Other Investments	2,159	1,128
	$ 56,493	$ 32,305

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 11 RELATED PARTY TRANSACTIONS

During 2009, the Company entered into an agreement with The Duchossois Group (TDG), a related party, for the purchase of real estate adjacent to Arlington Park. TDG beneficially owns more than 5% of the Company s common stock. The total purchase price of $27.5 million was financed by a cash payment of $3.5 million and a non-interest bearing promissory note of $24.0 million. During the nine months ended September 30, 2010, the Company fully repaid the promissory note balance of $24.0 million in accordance with the original terms of the promissory note.

NOTE 12 DISSOLUTION OF TRACKNET MEDIA GROUP LLC

During 2007, together with Magna Entertainment Corporation (MEC), the Company formed a venture, TrackNet Media Group LLC (TrackNet) through which horseracing content was made readily available through a variety of distribution points and wagering platforms in order to enhance growth within the industry. TrackNet ceased operations during the nine months ended September 30, 2010, and each party will now be responsible for buying and selling its own horseracing content. All existing third-party content agreements involving TrackNet were entered into by TrackNet as an agent for each Company-owned and MEC-owned racetrack. Accordingly, those contracts, and their underlying rights and obligations, will continue to be valid for the remainder of the contracts respective terms. There was no significant impact on the Company s consolidated financial position or results of operations for the three and nine months ended September 30, 2010 as a result of ceasing operations.