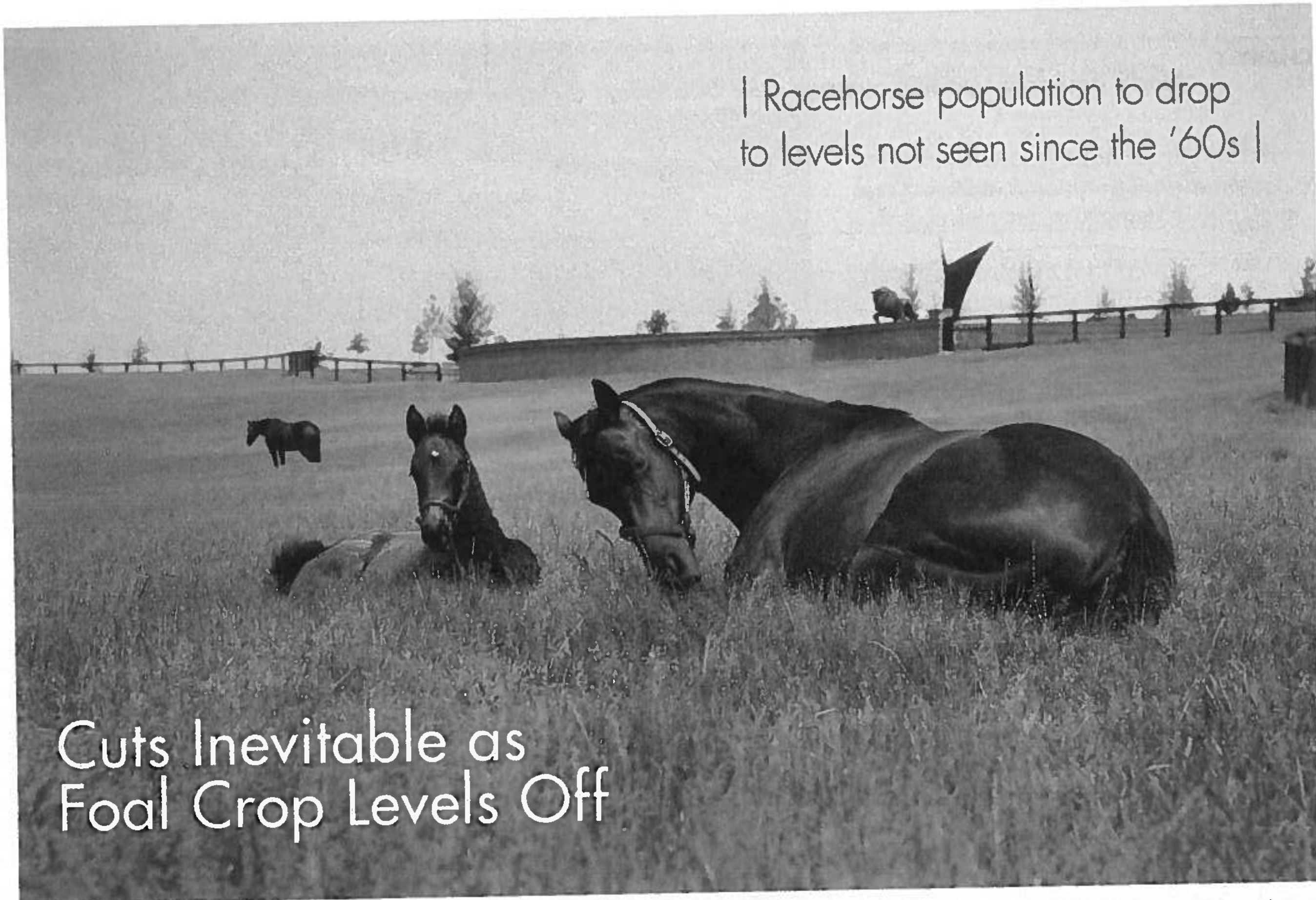


DAVID STEPHENSON

| Racehorse population to drop to levels not seen since the '60s |

Cuts Inevitable as Foal Crop Levels Off

The 2015 foal crop is projected to be 43% smaller than a decade ago

BY TOM LAMARRA

The North American Thoroughbred foal crop—including the United States, Canada, and Puerto Rico—will level out in 2015 at about 22,000 foals, according to estimates by The Jockey Club.

That's a positive development given consistent declines in the foal crop since 2006 that were exacerbated in 2008 because of the worst financial crisis since the Great Depression. In 2008 the foal crop stood at 35,265; only four years later it had fallen 33% to 23,500.

It remains to be seen if the projected leveling-off brings stability and, perhaps, incremental growth in the foal crop in the next five years. In the meantime, the industry—in both racing and breeding—must deal with the reality of foal numbers not seen since 1967.

The North American foal crop peaked at 51,296 in 1986. That year horses made a combined 744,833 total starts and there were 9.07 starters per race on average.

In subsequent years, however, the number of race days, or individual programs at each track, gradually increased and absorbed the influx of racing stock. Thus, average field size in North America didn't grow; in fact, it began to drop slowly and then remained static at just over eight horses per race for about 20 years.

The situation now is far more serious. Racing is coming off of a period of a major reduction in the production of foals and, even if we were to experience double-digit percentage growth the next few years (and there are no indications that will occur), it won't help fill races in 2015, or even in 2018.

The racing and breeding industry collectively isn't best known for being proactive, and the horse population issue is another example. Even in 2006, average North American field size came close to falling below eight horses per race, but little was done to examine the number of racing days comprehensively, not in small part because purses were being artificially supported by gaming proceeds, and because pari-mutuel wagering was holding steady.

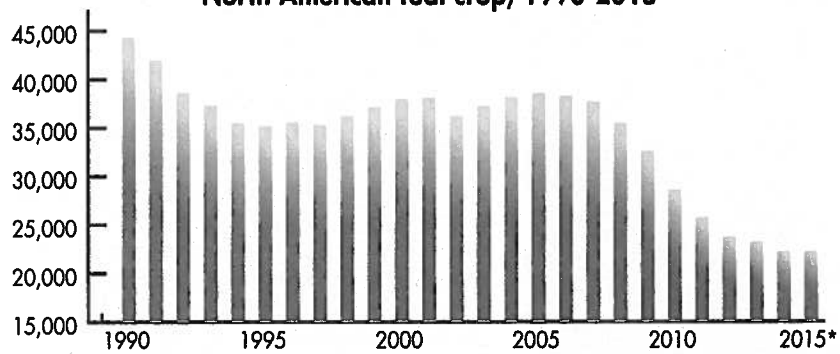
Forced into a corner, the industry has begun, albeit piecemeal, to address racehorse supply. The most recent example is Hollywood Casino at Penn National Race Course, which for decades has offered live racing year-round with roughly 200 programs per year.

The Pennsylvania track's 2015 racing schedule reflects a major break from tradition in that nine-race programs will be replaced by eight-race programs throughout the year. Penn National was approved for 193 racing programs this year, so there will be at least that many fewer races, and perhaps more with weather-related cancellations.

Chris McErlean, vice president of racing for track owner

CHART 1

North American foal crop, 1990-2015



*The Jockey Club estimate

Penn National Gaming Inc., said the decision, made jointly with the Pennsylvania Horsemen's Benevolent and Protective Association, was based on industry trends and projections. The primary objective, he said, is to avoid purse reductions.

"One consideration was available purse money based on current pari-mutuel and gaming trends and forecasts," McErlean said. "The eight races per night also would help stabilize daily and per-race averages (for purses). Obviously, a byproduct of the change in dates and races per night is hopefully to stabilize field size.

"Regional competition and weather this year are factors, but the reality of the overall available horse inventory due to contracting foal crops is another major factor."

Penn National averaged 7.20 horses per race in 2014, down 5.4% from 7.61 in 2013, according to The Jockey Club statistics. Purses for 197 days of racing in 2013 at Penn National totaled $35.3 million; the total for last year's 187 days was $32.3 million, an 8.6% decline.

Trimming races and racing days in today's business climate is more about necessity than it is devising an overall blueprint for the future of the racing and breeding industry. With a sustained healthy economy, it's reasonable to project more demand at auctions and incremental growth in foal numbers, but a return to production of even 30,000 foals per year clearly hinges on investment and improved return on investment.

The Thoroughbred Owners and Breeders Association has said the about $1 billion a year paid in purses is only one-third to one-half the total investment made each year by Thoroughbred owners and breeders. A 2014 survey of about 270 owners indicated the average cost per horse in training was $40,400.

"As a sport, we need to focus on new investment in Thoroughbred ownership and breeding," TOBA president Dan Metzger said. "In recent years we have witnessed increases in the yearling sales prices, which is encouraging for breeders. In order to continue those upward trends, we need to widen our markets for all bloodstock, not just the offspring of the top-tier stallions.

"From a racing viewpoint, average purses have risen significantly at many racetracks, which will enhance the owners' opportunities for a return on investment. Expenses are proportionally high for racehorse owners, and trainers need to be more assertive in controlling expenses."

Metzger acknowledged the emotional and recreational factors that lead people to invest in the business—and the tax write-offs that make years of losses bearable—but he added that the industry must work to improve the bottom line for owners. Under the current financial structure, that's a tall order.

The real short-term benefit for owners could come from the contraction already well underway: fewer unique starters and shorter fields, thus more opportunity to cash purse checks. But short of major new investors spending millions of dollars, key indices such as mares bred and the resulting foal crop will be fortunate to return to even 2010 levels. MW

DAVID STEPHENSON

CHART 2

Trend in North American field size, race days, races, and starts, 1990-2014

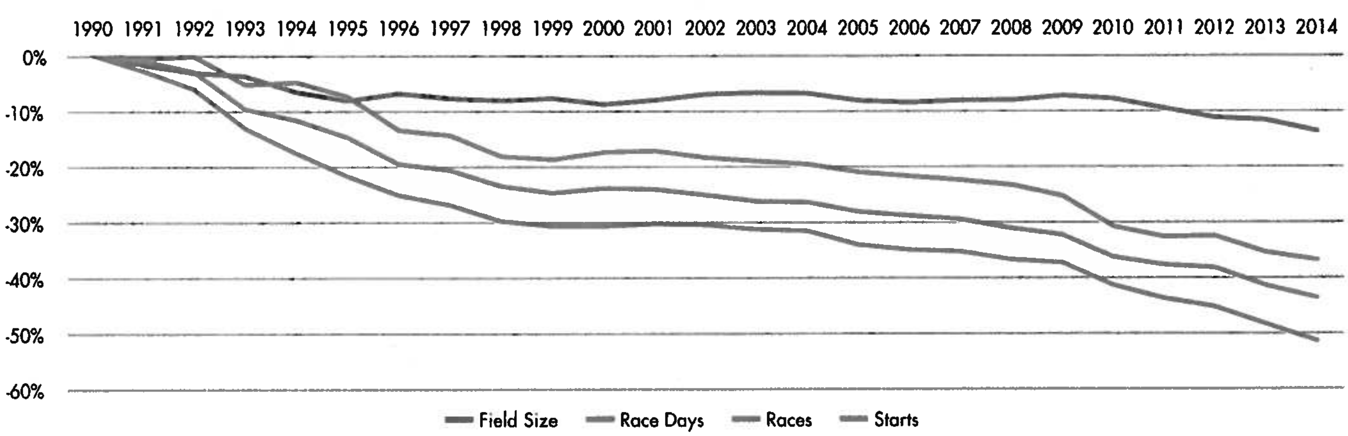
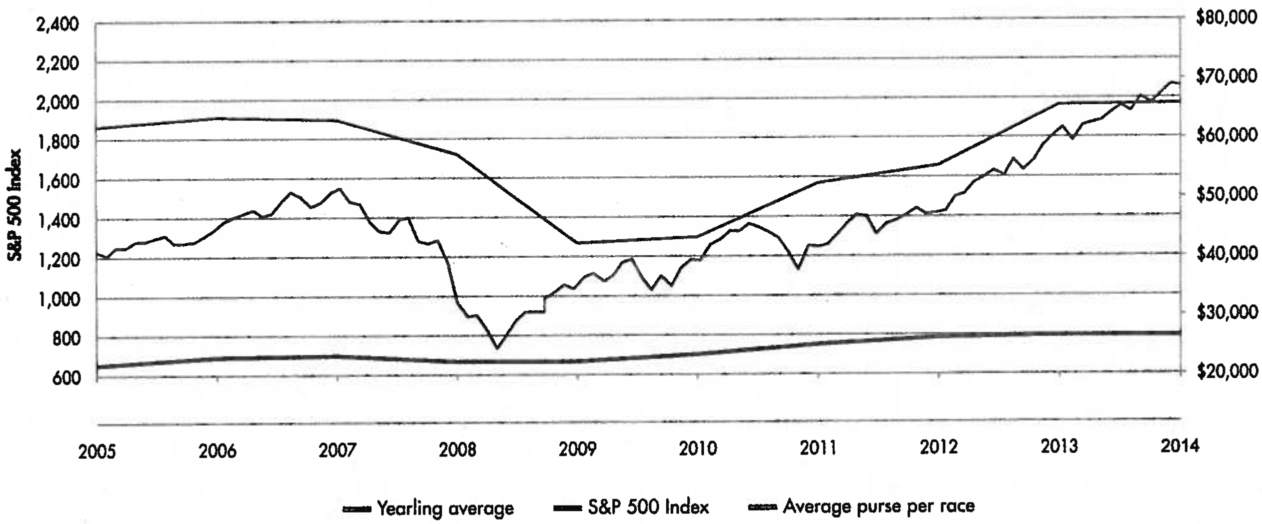


CHART 1

North American yearling average, S&P 500 Index, and average purse per race, 2005-14



OUTLOOK

Research by Robert L. Losey, Ph.D., a *MarketWatch* contributor, found that U.S. yearling auction prices vary to a large extent with the S&P 500 stock index (a proxy for the wealth effect and investor sentiment) and purse levels at Thoroughbred racetracks (see Chart 1). Accurately predicting stock market performance in the short term on a consistent basis is elusive, whereas near-term projections pertaining to purses can be made with a high degree of confidence.

In recent years, though aggregate purse levels have not kept up with inflation, average purse levels have grown at a rate greater than inflation, owing to the ongoing decrease in the number of races held. This tendency should continue and bodes well for yearling prices in 2015.

Inflation in the United States has been relatively tame at an annual rate of 1.7%, which is below the 2% target of the Federal Reserve. Subdued inflation makes raising prices for stud fees more difficult and thus contributes to enhanced profit margins on yearling sales.

Another factor favorable for 2015 yearling prices is that—according to the latest projection published by The Jockey Club—the registered foal crop in 2014 will be down approximately 4.3% from 2013, translating into a lesser supply of yearlings in 2015.

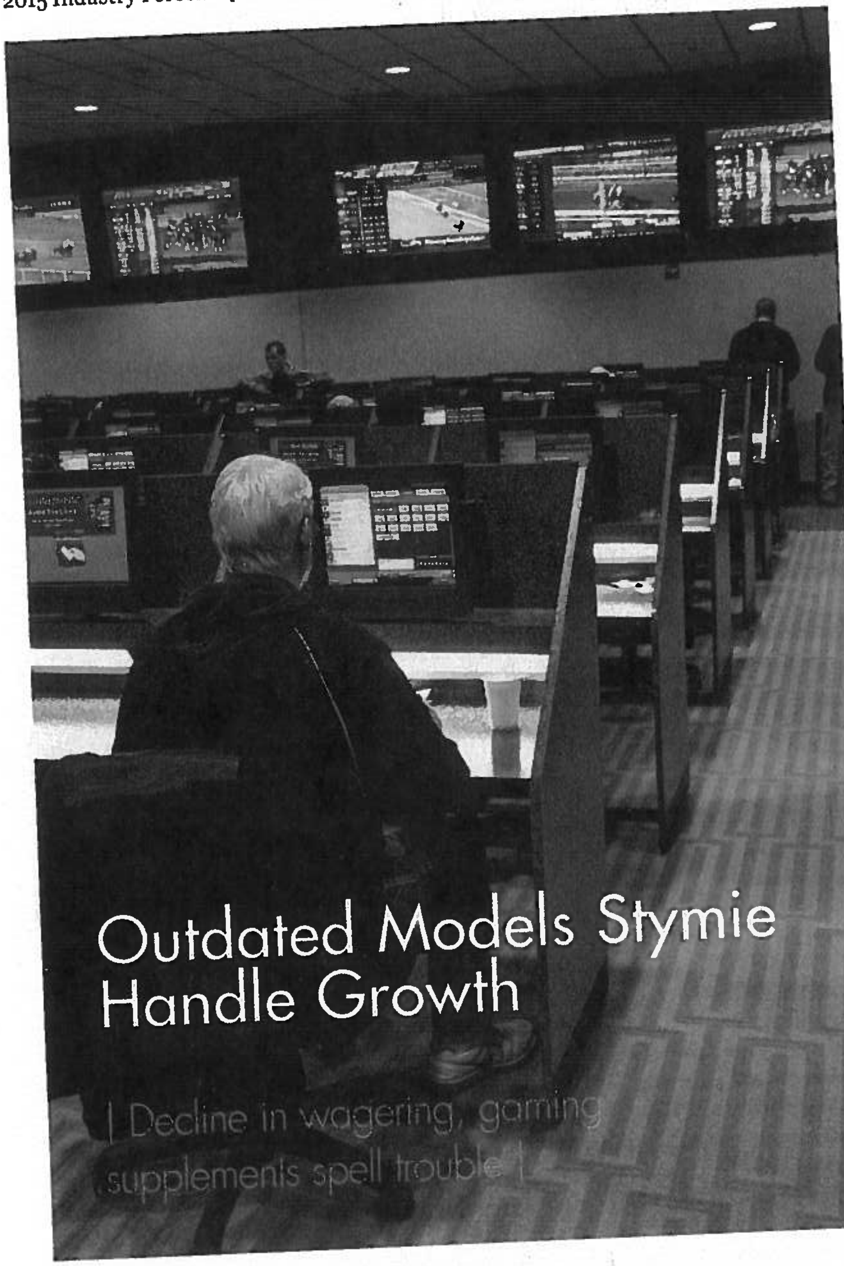
Conversely, the tenuous macroeconomic environment outside North America poses a threat of spilling over to the United States and Canada. Additionally, U.S. stock markets are vulnerable to likely interest-rate increases in 2015 by the Federal Reserve, and asset prices are a function of interest rates. Lastly, the U.S. dollar is likely to continue to strengthen against most world currencies, making yearlings purchased in America more expensive for buyers domiciled overseas. MW

TABLE 2

North American yearling sales statistics, 2005-14

Includes yearlings sold on or after June 1

Year	No. Offered	No. Sold	% RNA	Gross	Average	Median	Colt Avg.	Filly Avg.
2014	8,688	6,487	25%	$412,278,893	$63,555	$25,000	$73,315	$55,076
2013	8,062	6,417	20%	$411,128,630	$64,069	$25,000	$72,768	$57,120
2012	7,786	5,975	23%	$332,807,758	$55,770	$21,000	$63,277	$48,965
2011	8,515	6,411	25%	$327,751,931	$51,123	$17,000	$58,590	$44,424
2010	9,776	6,941	29%	$293,217,931	$42,244	$11,000	$49,752	$35,409
2009	10,411	7,186	31%	$307,286,001	$42,762	$10,000	$48,791	$37,788
2008	11,707	8,071	31%	$447,744,889	$55,476	$15,000	$63,228	$48,947
2007	12,284	8,969	27%	$537,294,709	$59,906	$16,000	$68,095	$53,351
2006	12,220	8,897	27%	$556,038,746	$62,497	$15,000	$75,658	$50,681
2005	12,197	8,938	27%	$551,402,996	$59,454	$15,000	$72,024	$46,192



Outdated Models Stymie Handle Growth

| Decline in wagering, gaming supplements spell trouble |

KEVIN THOMPSON

From 1995 through 2003, handle on Thoroughbred racing grew by $4.5 billion and remained fairly steady for the next four years

BY TOM LaMARRA

As 2014 came to a close, total pari-mutuel wagering on Thoroughbred races in the North America was projected to be comparable to figures registered in the early 1990s, which had been followed by a strong 10-year period of growth.

In 1995, the first year total commingled handle on races in the United States, Canada, and Puerto Rico cleared $11 billion, there were 7,984 race days and 8.17 starters per race, according to The Jockey Club. In 2013, with total handle of a comparable $11.36 billion, there were 5,556 race days and an average field size of 7.85 horses per race.

At face value an argument could be made that, despite a 30% reduction in the number of race days and a 3.9% decrease in field size, handle in 2013 was slightly higher than it was in 1995; therefore, the pari-mutuel market has made the necessary adjustments because average wagering per race day has increased.

Increased per-race-day average wagering is a good thing, but can it sustain a massive contraction in available product?

It would be folly to ignore a 10-year period in which North American handle grew each year from $10.57 billion to $15.71 billion in 2003—an increase of 49%—and the subsequent 10 years through 2013 in which handle toppled to $11.36 billion, a decrease of 28%.

The growth spurt came at a time when full-card simulcasts at racetracks, off-track betting parlors, and race books at casinos were at their peak. In addition, advance deposit wagering was ramping up as new jurisdictions legalized that form of betting, and as boutique Internet wagering outlets that catered to big bettors—"whales"—and offered substantial rebates entered the market.

From 1995 through 2003, aggregate annual Thoroughbred handle grew by $4.5 billion and remained fairly steady—in excess of $15 billion each year—for the next four years as operators mined an upside-down pari-mutuel revenue system that began when full-card simulcasts were launched in the 1980s. But, during the same period, total purses in North America were flat.

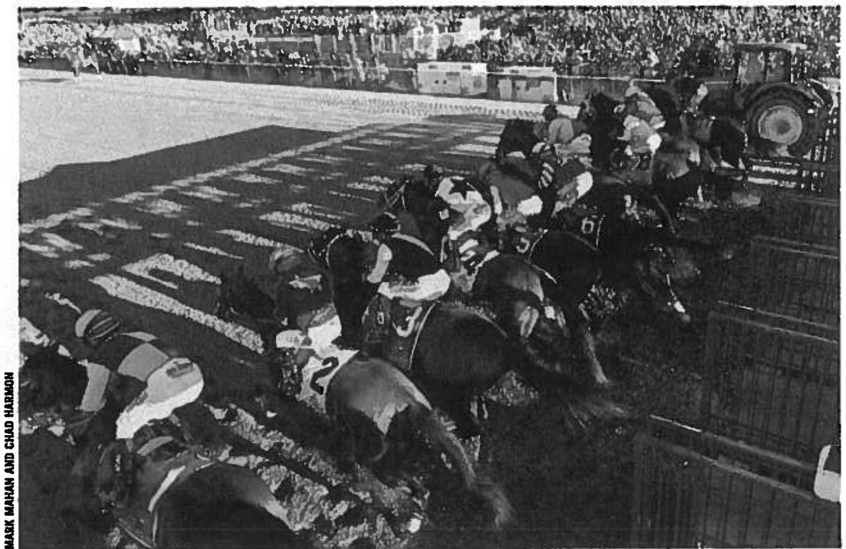
Racetracks considered it found money when they could transmit their signals for betting purposes to out-of-state locations, and, as such, settled on a pittance, roughly 3%, in return. Meanwhile, the receiving facility, after paying the 3%, kept the remainder, or about 17% before taxes based on a 20% blended pari-mutuel takeout rate.

Much of that revenue, at the outset, was going to racetracks that offered their own live racing as well. With the launch of ADW services that had no such bills to pay, a larger percentage of the wagering dollar became available for rebates to the biggest bettors.

Any "new money" realized during that period appears to be gone. Online wagering, not surprisingly, continues to make up a larger percentage of total handle in Thoroughbred racing, but, given wagering trends since 2009, it hasn't developed into the golden goose it was touted to be more than 10 years ago.

If anything, handle has merely shifted from one outlet to another, often with serious ramifications for purses, which benefit more from on-track business than Internet betting systems and non-track betting parlors.

During the last few years the Thorough-



MARK MAHAN AND CHAD HARMON

Purses have shown no sizeable growth since their peak in 2007

bred Racing Associations, a racetrack trade group headquartered in Maryland, has researched handle and purse trends in the U.S. with an emphasis on revenue derived from non-pari-mutuel sources such as slot machines, video lottery terminals, and other casino-style games. The numbers can be used to help project where the industry is headed.

U.S. Thoroughbred purses in 1993, just before the opening and spread of racetrack casinos, totaled $691.1 million, of which about $529,000 (only 0.08%) came from non-pari-mutuel sources, according to the TRA. In 2013 purses totaled $1.12 billion, of which more than $400.4 million (36%) was derived from casino games.

But while the artificial purse contribution grew every year but one from 1993-2013, total purses have been stagnant for the past eight years. Thoroughbred purses totaled $1.03 billion in 2000—the first year prize money topped $1 billion—and in 2013 totaled $1.12 billion.

That's an increase of 8.7%. But U.S. purses hit their high point of $1.18 billion in 2007, and since that year have shown no sizeable growth.

The TRA research also shows another statistic—purses that are derived from the takeout rate on handle. In 1993, 7.2% of total U.S. handle went to purses; in 2003 that figure fell to only 6.0% and in 2013 came in at 6.7%.

(The racing association collects a blended takeout rate of about 20%. Purses and track operations each take similar portions of that 20%; these amounts vary on a track-by-track basis but are generally proprietary and subject to contract negotiations. The rest of the 20% goes toward taxes, fees, and wagering rebates.)

The amount used for purses has remained below 7% since 1996 even though some racetracks and horsemen's groups over the past decade have said the goal is to increase the share of handle that goes to purses. Based on the TRA figures, that hasn't occurred in a meaningful way, in part because of the shift of wagering from on-track to off-track and non-track sources; more revenue is generated via on-track wagering than from other sources.

National Thoroughbred Racing Association chief executive officer Alex Waldrop called the system "complicated," and said it could be more so in the future given the advent of legal fantasy sports wagering and the possibility of legalized sports betting on live events.

"The environment is changing so rapidly, and the gambling mix is evolving quickly," Waldrop said. "We have to be nimble to whatever occurs."

But Waldrop also said he doesn't expect the industry to address its fundamental pricing model, and that he expects the racetrack casino environment to continue to be a "haves vs. have-nots situation" in which some tracks supplement purses with non-pari-mutuel income while others do not.

So given the climate of stagnation in pari-mutuel wagering and reductions in casino revenue—and in turn a drop in money available to supplement purses—because of intense competition for gaming dollars in several major racing regions, there appears no legitimate reason to project meaningful growth in handle and purses over the next five years.

The industry thus far has been unwilling to explore comprehensive reform in regard to simulcast revenue splits and pari-mutuel takeout rates to make it more attractive and competitive with other forms of gambling; growth in wagering on U.S. races via overseas markets is continually hindered by foreign provincialism, a lack of commingled pools, high tax rates, and time-zone differences; and horsemen and breeders unwisely continue to rely almost exclusively on an artificial revenue-producer that is subject to the whim of legislative money-grabs. MW

CHART 1

North American handle and purses, 1990-2014