SNAI SpA

"Third Quarter 2014 Results Conference Call"

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MODERATORS: MARCO CODELLA, CHIEF FINANCIAL OFFICER

OPERATOR: Good morning. This is the Chorus Call conference operator. Welcome and thank you for joining the SNAI Third Quarter 2014 Results Conference Call. After the presentation, there will be an opportunity to ask questions.

At this time, I would like to turn the conference over to Mr. Marco Codella, Chief Financial Officer of SNAI. Please go ahead, sir.

MARCO CODELLA: Good morning, everybody, and thanks for attending this call today. First of all, I would like to apologize for some problems we are experiencing with our website, since the presentation seems to be not available. So while the problem is fixed, I would try to just give you some info about our performance in Q3 and some additional details on our business and on our strategy for the near future.

First of all, I have to give you some view about what we actually did during this period. We got very good results from betting on virtual events since we achieved €33.4 million in terms of revenue with wagers that equaled €262 million in the first nine months of the year. During the third quarter, we actually achieved €80.2 million in terms of wagers and 11.3 mio in terms of revenues. This is a bit lower as compared to the previous two quarters of the year, since wagers…sorry since virtual events are mostly collected offline in shops, and therefore, there is some seasonality which is related to the summer period.

For what virtual events are concerned, it is worth reminding that we just renewed the contract that we had in place with Inspired, we renewed it until 2020 at better economic conditions. It is also very important to remind that the market share that we achieved at the end of September on virtual events is in the range of 38%.

We got a very solid performance in sports betting payout since we achieved , at the end of September , 77.2% as compared to 78.6% in 2013. And this happened despite the expected negative effect of World Cup where normally the payout is higher than the average because, you know, the number of single and double events bets during the World Cup is higher than the standard. But based on the new contracts we have in place, and based also on the automatic controls that we put in place in our system, we were able to better manage and control the payout.

For what wagers are concerned in sports betting, they were down mainly because of the additional 950 new shops that were deployed in the territory after the 2013 new concessions awards and this was also due to the very aggressive competition from CTDs.

For what the total wagers are concerned, on sports they were down by some 7% and this was mainly due to the choice we made in order to have a higher quality in terms of wagers accepted and to introduce some stricter control on them. This was repaid through our performance in payouts because, we do not have official figures provided by ADMs, it is a very good estimate that our performance is some 1.5% better than the market. So the payout we achieved from our offline sports betting was 76.2% in the first nine months of the year, as compared to payout in the online part of our business that was around 81.6%.

For what gaming machines are concerned, our performance improved in VLTs since we completed at the end of last year the rollout of the 5,052 rights that we bought in 2009. At the end of September, we had 4,858 VLTs operational and there were 194 VLTs that were under relocation plan.

What we are experiencing in this part of our business is that the average coin-in in Spielo is going down while the average coin-in in Novomatic is going up quite significantly. And we think that this is mostly due to the fact that Spielo is redistributing less money to gamblers if we take out the effect of the national jackpots. Also, Spielo is not including any free spin mechanism that is something which allows players to spend a longer time in front of the VLTs. Novomatic has got th this feature, so we are experiencing a significant increase in Novomatic average coin-in. Nevertheless, the performance in VLTs was lower than expected due to late availability of low payout games and also due to technical updates that were required by ADM.

For what the low payouts games is concerned, we expected to have them effective from January the 1st. Unfortunately, Sogei approved them at the end of March. After that, we started the technical update process that was including not only the low payout games, but also the new releases of the technical platforms able to manage the 6% taxation on wins above €500 . This process was completed at the end of June and this of course, caused the number of…the average number of VLTs operational to be reduced during that period.

Another important topic is the fact that the fixed payout games account 58% of our total contribution margin at the end of September as compared to 51% after the first nine months in 2013. Through this, we are reducing volatility which is associated to our performance since the fixed payout games are at no risk for the bookmaker. Also, we were able to effectively manage our costs and to achieve significant savings on them.

Moving to the main financial highlights, we achieved €393.9 million in revenues as compared to €352 million last year; this is representing an increase which is in the range of 12%. In terms of contribution margin, we achieved €147 million at the end of September which is 13% above the performance at the end of September last year. In terms of EBITDA, our performance was €81.2 million versus €64.5 million last year and the increase in this case has been 26%. In terms of net income, we had a net loss by €9.9 million as compared to - €14.5 million last year, and this was affected by higher financial expenses as compared to 2013.

Some additional financial KPIs are related to the CAPEX that we booked during this period; the total at the end of September was €11.9 million which is compared to €32.8 million last year, but as you probably remember, last year we had some €17,5 million that were associated to concessions renewals, €14.5 million related to sports concessions, and some €3 million related to AWP VLT concession renewal.

Just to go back to the reported net loss, it is worth reminding that we obtained a ruling from Ministry of Finance under which settlement of CDC litigation is to be considered tax deductible, but this effect is not included in September figures. The net debt at the end of September was €424 million compared to €443 million at the end of December.

Moving to the EBITDA evolution, last year performance at the end of September was €64.5 million, changes to this figure were given by sports betting in the range of -€1.8 million; one million out of 1,8 is related to sports and this is due to the positive contribution of a better payout as compared to last year more than counterbalanced by the lower wagers.

For what the gaming machines are concerned, VLTs are contributing by €4.6 million to the increase of the EBITDA and this is I would say related to the increased number of machines that we have available in our network. While the AWPs contributed to minus €0.7 million to the EBITDA evolution, but they almost recovered 2013 levels. As You will probably remember at the end of first quarter in 2013 one of our main customers became a direct concessioner and took out from our network 3,500 machines.

A significant contribution to the increase of our EBITDA was provided by the virtual events.

At the end of September the additional EBITDA generated by virtual events is in the range of €17 million. It is again very important to note that our market share is some 38%; it is extremely high and in a segment where this industry can grow and is growing.

In terms of…a very quick view on our payout; what we achieved at the end of September is 77.2% which is made of a performance at the end of the first half of the year that was 78.3%, plus third quarter performance where we achieved 73.9%.

this is a very, very good performance as compared to the average and as compared to previous years.

Few words now on what I guess it is the main topic that the audience would like to addressed ; the proposed increase of taxation on gaming machines. The budget law is foreseeing an increase of taxation on VLTs to 9%, today it's 5% effective from April the 1st, together with a reduction of minimum payout level from 85% to 81%. It is also foreseeing an increase on AWP taxation from 13% to 17% together with a reduction of minimum payout from 74% to 70%.

Although the budget law was issued a couple of weeks ago, at the moment no specific details were provided. It is worth reminding that the budget law becomes effective at the end of Parliamentary approval process where it could be changed. In theory, if tax increase is made at the same time of payout reduction, the only effect on concessioners is on volumes.

An estimate which is agreed between analysts and you know, experts of this industry is that the effect could be some 25% on VLTs volumes and some 13% on AWP. And the idea which is behind the law is that such tax increase should fall completely on gamblers. The estimate is made on the assumption that gross gaming revenues are equaling the amount of money that players are willing to lose. I'll try to give you an example in order to make you understand how this 25% and 13% are calculated. Assuming that collection on VLTs was in the range of €1.4 billion per year with payout in the range of 88%.

The gross gaming revenues are 168, which is some 12% of total wagers collected. By keeping this 168 stable and reducing payout to 84% the GGR account for 16% of wagers. Applying new percentage to GGR (168 mio) obtain €1.05 billion which is €350 million less than the original wagers collected equal 25% less. This estimate is, you know, quite reasonable but it is assuming that the decrease of payout is synchronized with the increase in taxation. But in order to do so Sogei need to go through the approval process of all of the new low payout games, immediately after providers of the technology solutions have made them available.

It is worth reminding that in Italy, five games account for some 60% of total market. So therefore if Sogei are able to prioritize the approval of those games, at the end of the day, the effects in terms of time shifting between the increasing payout and then decrease…sorry the decrease in payout and increase in taxation could be significantly reduced. For what the AWPs are concerned, in order to achieve a payout reduction, a substitution of the motherboard inside the terminals is needed.

In terms of what the budget laws foresee about the additional income which is expected by the Italian government to come from this measure, the technical report that goes together with the budget law and gives estimates on each single measures effect, is reporting that no additional tax income is expected from gaming machines tax increase. Difficult to explain, difficult to find a rational for that, but this means that removing the tax increase from the budget law would be just a matter of political will, with no effects on budget itself.

Although the theoretical effects of proposed law are significantly negative, We can anyway identify some opportunities in it , some opportunities are for all of the official concessioners, one is special for SNAI. The first one is that, for the first time , operators not acting based on concessions, the so called CTDs, but are operating based on ruling from the European Court, I would say for the first time these operators will be taxed in Italy. And through this , they will be losing the competitive advantage on odds offered to their customers, due to the fact that they are not paying any tax on their side, and the competition with them becomes more fair. The budget law is foreseeing some €900 million coming from taxation of CTDs. All of the income which is expected by the government from this measure is coming from the taxation on CTDs. As I was saying before, no additional tax income is expected from, you know, gaming machines tax increase.

There is also a significant opportunity for SNAI. We have been experiencing a significant cannibalization from VLTs to virtuals, evidence for this is that VLTs located in arcades where virtual events are not available, are performing minus 5%, as compared to last year on a comparable basis.

VLTs which are located in betting shops, where virtuals are available , are doing minus 20%. If you consider that our market share in virtual is around 38%, I mean total brand market share this is… if VLTs become less appealing, and as you can easily understand by reducing payout and increasing taxation VLTs become by far less appealing, it is likely that the ongoing switch from VLTs to virtual will furtherly grow.

Additionally, it is worth reminding that the contribution margin on VLTs, today, before any change in tax or payout is 2.8% on wagers. The contribution margin from…coming from virtual is 6.5%. Additionally, as you probably remember, we have a contract in place with Inspired which is the main supplier of the technology platform for virtual events, under which we have an exclusivity period with them on each new single game they are launching, after that period Inspired is allowed to provide other concessioners with this new games, but we are rewarded with a percentage of wagers collected through the other concessioners' network. So for us this could be a significant opportunity that somehow could reduce the negative effect of increased taxation on VLTs.

I think, we could now move to the Q&A session, if any question is placed and please go ahead with questions, if any.

Q&A

OPERATOR: Excuse me; this is the Chorus Call conference operator. We will now begin the question and answer session.

The first question is from Ms Jennifer Hallowell of Deutsche Bank. Please go ahead, madam.

RONAN CLARKE: Hi, actually it's Ronan Clarke from Deutsche Bank.

MARCO CODELLA: Hi, Ronan.

RONAN CLARKE: Hi, Mark.

RONAN CLARKE: I wanted to ask you I guess first of all; maybe you could frame this in terms of the guidance because it seems like you are well ahead of what you were suggesting for FY14. So can you update that and then for next year to help us understand you know, the impact of the VLT tax and virtual games, any thinking for next year's guidance already?

MARCO CODELLA: Okay. So about the 2014 guidance, we do not foresee changes on that. For the 2015 and '16 guidance or better for the range or EBITDA, we communicated to the markets related to the end of 2016, we are in the process of reviewing our financial plan together with the budget process for next year. At the end of the process, we will be able to provide the market with new guidance, if any.

RONAN CLARKE: Okay. And will you be doing that, or you think you are waiting until…we have to wait till April to get clarity on for FY15 or before hand?

MARCO CODELLA: We are planning to have the budget officially approved by our Board as we are committed to do based on our financial contracts by the end of January. In the meantime, at the same time, I mean the Board should also approve the new 2015, '16, and '17 figures, planned figures.

RONAN CLARKE: And I am curious why you wouldn't change FY14 at this stage, where the LTM is ahead of it, is Q4 not up to expectations or is it something about the margin not so strong, sports margins?

MARCO CODELLA: You know, normally payout in Q4 is not that good on sports, on sports betting. And therefore, we must be cautious with that.

RONAN CLARKE: Okay. But virtual is maintaining the momentum in Q4, right?

MARCO CODELLA: Definitely, yes, yes, no change.

RONAN CLARKE: Yes, okay. And maybe just one last one, just to maybe spell it out in terms of what you said, which is very helpful in terms of the 25% wager impact from the reduction in payout. What's the estimated impact in total and EBITDA if you get the tax changes applied as outlined?

MARCO CODELLA: If you consider the effects on volumes, in terms of VLT, the effect should be somewhere around €6 million and €7 million. If the estimate of €25 is correct, then the effect should be around say €6 million to €7 million in 2015.

RONAN CLARKE: Okay.

MARCO CODELLA: But consider that the new tax increase would be effective from April the 1st. So if no changes are made to the budget law, the tax increase is expected to be effective April the 1st, so three quarters.

RONAN CLARKE: Okay, okay, that's very helpful. Thank you very much.

OPERATOR: The next question is from Andrea Randone of Intermonte. Please go ahead, sir.

ANDREA RANDONE: Hi, Marco hello.

MARCO CODELLA: Hi Andrea

ANDREA RANDONE: Yes, my first question is about just an update on your figures in October, if you can provide us any color about that. And the second is about, something you reported in your quarterly release regarding the possibility to acquire a company, SIS, which is a company which is already operating with you. So if you can comment this opportunity, yes, I think that's all?

MARCO CODELLA: For what the October figures are concerned, as you know, we are a public company and the figures must be officially released in order to make them available to everybody. But we…normally what we expect in the last part of the year is some increase in terms of sports betting payouts. The other segments of our activity should be in line with previous quarters and previous months. For what SIS is concerned, SIS is one of our main distributors. They own 55 shops in the Italian territory. The idea of acquiring SIS is related to some opportunistic, you know, ways of dealing with them. we could defend our position in terms of receivables by acquiring them through conversion of our receivables versus SIS. So it is not a strategic acquisition, it would be an opportunistic acquisition, a defensive acquisition.

ANDREA RANDONE: Thank you, Mark. And just about at this point, can you update also if you…about I mean, the net debt expectation for the end of the year?

MARCO CODELLA: We expect to be in line with the guidance we provided to the market because as you know, we are today enjoying some, longer terms for the payment of tax on sports and horse races betting. And this longer term will will be back to standard at the end of November. the positive effect of these , you know, longer terms will be completed, will be off by the end of the year. And we expect the operations in the third quarter, the positive effect of operations in the third quarter, to counterbalance the negative effect of the reduced terms of payment on tax.

ANDREA RANDONE: Thanks a lot. Very clear.

OPERATOR: The next question is from Mr. GianLuca Pediconi of MOMentum. Please go ahead, sir.

GIANLUCA PEDICONI: Hi, Marco.

MARCO CODELLA: Hi.

GIANLUCA PEDICONI: I've got couple questions on the payout, sports betting payout because I understand from your comments that there is in place a better management control, I understand you are making some investments. Q4 we know the seasonality, but we should extrapolate from this that in 2015 and ongoing, the payout should be better than what we used to see at SNAI, that is the first part of the question. The second one is the difference in the payout between offline and online, considering that the online is growing more means on the other side that we will see a worsening just due to the different mix in the future?

MARCO CODELLA: Okay. First question, in theory you could expect the same performance in the future, but I think it is not a matter of percentage of payout by itself . You need to take into account the difference and the better performance that we are achieving as compared to the market. That's the right way to try and estimate our performance in terms of payout. Today, we are 1.5% better than the market. And this is mostly due to the activities I was trying to describe before. So our goal is to be better than the markets, but you know there is a risk which is associated to the results of the events that cannot be managed by us.

GIANLUCA PEDICONI: Sure. But do you believe that this 1.5% is sustainable or the competition will catch up?

MARCO CODELLA: Difficult to say. As of today, we are doing better than the competition. The second question related to the payout in online and offline. You are right in saying that normally the payout that we pay on the online is higher compared to the offline part of our business. And going forward, if the online part of our business is growing and it is very likely that this will happen, that could be…could result in some lower margins. But you need to remember, that we are not paying any distribution cost on the online part of our business. Therefore, the difference could be in the range of 8% on wagers which is by far lower than the difference between offline payout and online payout in average.

GIANLUCA PEDICONI: Yes. Just a follow-up question, can you disclose how much do you…have you spent in the first nine months in marketing cost?

MARCO CODELLA: We are around €5.5 million.

GIANLUCA PEDICONI: Thank you very much, Marco. Thank you.

OPERATOR: The next question is from Mr. Domenico Ghilotti of Equita. Please go ahead, sir.

DOMENICO GHILOTTI: Hi, Marco. A couple of questions, the first is a follow-up on the payout because you are commenting that you are 1.5% better than the market and you hope this is probably a structural gap. But don't you think that this is a risk in terms of market share? Can you comment also on the market sharing in Q3 and in particular if there is a structural difference between SNAI and the market overall. The second question is on the cost savings initiatives that you are mentioning. Can you elaborate a little bit more just to give us an update on total amount that could be expected this year and maybe next year?

MARCO CODELLA: Okay, first question on market share. For sure, if we achieve a payout which is lower than the market, that could somehow affect our market share and most of all wages we collect. But this is more than counterbalanced by the higher quality of wagers accepted and measured in terms of better payout that we achieve. So it is a risk, but we are you know managing it. And another opportunity in order to increase our wagers next year is coming from what we tried to describe before, and it is related to taxation of CTDs. If CTDs are subject to taxation…to gaming taxation in Italy, they will not be allowed to provide customer with better odds anymore. And therefore, we have a very good opportunity to increase wagers next year, taking them out of the CTDs network.

Cost saving activities are mostly related to personnel cost. As you know, we sold the outbound activity…our outbound call center activity at the beginning of this year and we reduced the cost of personnel by €1.5 million on yearly basis. We are, you know, significantly reducing consultancy costs, and we are then also managing, you know, the maintenance activities and services that can be achieved at a lower price. We are not decreasing marketing costs. If you compare marketing costs this year, to the figure we had in place at the end of September last year, the increase is quite significant. I don't know if I answered your question.

DOMENICO GHILOTTI: Yes, and just a follow-up on the CTD taxation. Do you think that with current law as written in the stability law, it can be really effective because in the past we have seen several say trial to tackle this issue?

MARCO CODELLA: Domenico, you put the question, but you know, the answer, I mean…

DOMENICO GHILOTTI: No, I mean. No, it probably depends on the way they are really writing the law and…

MARCO CODELLA: It depends by the final wording of the law. For sure there will be…

DOMENICO GHILOTTI: Are you more confident let's say…let's put this way. Are you more confident with the current formal legal structure of the law?

MARCO CODELLA: There is a strong will from our government to tax CTDs. I don't know if the…the wording which is today included in the budget law is the right one. But the will from our government is very strong on that.

DOMENICO GHILOTTI: Okay. Thank you.

OPERATOR: The next question is from [indiscernible]. Please go ahead, sir.

ANALYST: Yes, hello. Thank you very much. I have to admit, I haven't been following SNAI for two quarters or so. And I have a little bit of catching up to do. First of all, with respect to virtual events, can you just tell me again when you began with virtual events and how that growth story has unfolded to-date and what your views are on that going forward, how I should think of virtual events growth in the next years?

MARCO CODELLA: Okay, we launched virtual events at the end of December last year. So this is actually the first year in which we are enjoying the effects of having this, you know, new kind of activity in our shops. We are collecting some €85 million per quarter. And in average collection is generating some €11 million in terms of revenues per quarter. We have a contract in place with Inspired which is the main, you know, technological player in this segment of activity and we have with them an exclusivity period. So the first concessioner was allowed to launch the new games from Inspired in SNAI. After a certain period of time, Inspired is allowed to provide new game to other concessioners but are rewarded with a percentage of on wagers collected by other concessioners. As I was saying before, very recently we renewed the contract with Inspired that was supposed to be completed by the end of 2016 and we extended the contract to 2020 at better economic conditions.

In terms of market dimension, we do expect at the end of this year the market to be in the range of €1 billion, €1.1 billion which is very similar to the UK market which is around 1 billion pounds. In terms of future years, we do not expect additional significant growth in this area, and this is also based on the UK history of this kind of activity where there was very quick ramp up of wagers and then they remained stable for a long period of time.

What we are doing on virtual events, it's trying to increase the number of events that we are broadcasting everyday. Today, we are in the range of 500 events. We are planning to add an additional TV channel to increase the number of events that we are able to launch…to broadcast everyday. Therefore, what we plan to do is to increase wagers collected through increasing the number of events that we will be broadcasting. Additionally, just to give you a view on that is, it is worth reminding that 95% of wagers are collected offline in our shops and corners and only 5% is collected online.

ANALYST: Okay, thank you. Can I just ask for how long would the exclusivity period last? Is this a matter of months or years?

MARCO CODELLA: It's a matter of months.

ANALYST: Okay, thank you. And something else on, parts of Italy, Milan, Fermo and Veneto, have been showing some increased negative sentiments to gaming halls with sort of different types of limits to locations operating hours et cetera, if there is an increase in trend and how are you being affected by that. I don't believe you actually own a hall.

MARCO CODELLA: We do not own halls**.** You're right in saying that opening new gaming halls in Italy is becoming more difficult. To be honest, most of the decisions taken at local level were then rejected in courts or at least suspended in courts. So as of today, most of the decision taken by local authorities are not effective because there is a strong need from central government in order to keep the level of tax income coming from the industry at the stable level. So there is a conflict of interest, between local authorities and central authorities. Based on this, as of today, most of the decisions taken locally are not effective. I think maybe, we could leave room to other people for the…for a very last question and then we can complete the call. Anybody else?

OPERATOR: And the final question is from Helen Rodriguez of BNP Paribas. Please go ahead, madam.

HELEN RODRIGUEZ: Thanks very much for the question. Can I ask for the virtual market, if you have 38%, who has the rest of the market?

MARCO CODELLA: Actually, we do not have detailed figure coming from ADM, because ADM is not providing the market with any official figures since October last year. As far as we know, there should be other concessioner in the range of 12% to 15%, but I mean the second competitor is less than 50% of our market share.

HELEN RODRIGUEZ: And who is that?

MARCO CODELLA: It should be Sisal.But the difference between us and them is also that, we are broadcasting through our TV network. They are sending virtual events to their shops through streaming ; from a technical standpoint TV broadcasting is much better.

HELEN RODRIGUEZ: Okay. And then can you just go over again what you said, in the shops…the betting shops where you have virtual and VLTs, you have 20% down VLTs.

MARCO CODELLA: Yes, on a comparable basis, yes.

HELEN RODRIGUEZ: And for the ones where you…where it's just the VLTs, they are just down 5%. Is that correct?

MARCO CODELLA: Yes, it's correct. And the difference between arcades and shops is that in arcades you do not have virtuals. So it's a strong clue that there is, you know, cannibalization from VLT to virtual.

HELEN RODRIGUEZ: And is there any evidence from the UK?

MARCO CODELLA: I have no evidence on that.

HELEN RODRIGUEZ: No, like you know how it goes after this, if VLTs continue to, you don't have evidence, okay fine.

MARCO CODELLA: No, the very last one.

HELEN RODRIGUEZ: The very last question. In terms of the third quarter specifically, was the main delta the virtual, or was there anything else that I am missing, the revenue was a lot higher than I expected?

MARCO CODELLA: It is virtual and it's a very good performance on sports-betting payouts.

HELEN RODRIGUEZ: Okay. Alright, thank you.

MARCO CODELLA: So thank you everybody and sorry for this technical problem with our website that I hope in the meantime has been fixed. We'll keep in touch on the development of this budget law. Thank you everybody.