

CryptoLogic Inc.
2004 First Quarter Results Conference Call
May 10, 2004

Operator: Please stand by; your meeting is about to begin and please be advised that this conference call is being recorded.

Good morning Ladies and Gentlemen and welcome to the CryptoLogic First Quarter 2004 Results Conference Call. I would like to turn the meeting over to Mr. Lewis Rose, President and Chief Executive Officer. Please go ahead Mr. Rose.

Lewis Rose: Welcome ladies and gentlemen. Thank you for joining us on this spring day for CryptoLogic's 2004 first quarter conference call. I'm Lewis Rose, President and Chief Executive Officer of CryptoLogic. With me today are Jim Ryan, our CFO, and Nancy Chan-Palmateer, our Director of Communications.

I am pleased that CryptoLogic is starting 2004 on such a strong footing. We achieved record revenue in the first quarter, and our earnings have more than doubled from the same period a year ago. While these are wonderful results, we do not expect to maintain the same year-over-year growth rates as we saw this quarter.

CryptoLogic's success in the first quarter was all about having a clear, straightforward strategy and the discipline to stick to it. As a result, we are capitalizing on the vast potential of the growing global online gaming industry.

You have heard me speak consistently about the three core elements of this strategy:

- 1) International diversification;
- 2) Market-oriented products; and
- 3) Regulatory leadership.

I shall address each strategic priority in turn.

Firstly, we anticipated that the near term growth prospects for Internet gaming were shifting to the international stage. Accordingly, we have emphasized a global strategy and diversified our market reach, particularly in Continental Europe and the UK - and it's paying off.

Our licensees' revenue from international markets rose to approximately 60% of total revenue - up from 55% in 2003 and about 40% in 2002. UK and Continental European markets alone now account for approximately 30% and 20% respectively of overall revenue.

We have been strategic in the diversification of our customers - consciously focusing on a smaller number of major licensees that will generate the best "return on effort". We target leading global gaming organizations with a trusted brand, an established customer base with a propensity to game and the strong financial commitment to market their sites. Our newest licensee, Betfair, is a perfect example.

Betfair is the world's largest betting exchange and a well-known gaming brand in the UK, with over 100,000 customers matching over £50 million in bets per week. Betfair's entry into the player-to-player online poker arena using CryptoLogic-developed software, represents exciting synergies with its existing person-to-person betting exchange model. This promises to be a winning hand for both Betfair and CryptoLogic.

Secondly, product diversification remains core to our success in the first quarter. We continue to invest in new game development and enhancements such as the new 9-line slots games, the innovative integrated slots and bingo product, and more importantly, the new Millionaires Club which is a progressive jackpot and provides players with a chance to win \$1 million. Indeed, a lucky player from the UK won over £436,000 on a £3 play just ten days ago.

We are clearly seeing the benefits from these new games with licensees' revenues from the casino software continues to grow.

We are especially excited about online poker. It's a great example of our strategy of delivering market-oriented solutions, which drive incremental revenue for our licensees and extend their business into large new gaming audiences worldwide.

Poker is the largest growth market in Internet gaming today, and is catching the attention of both online gamers and recently the more traditional, land-based players. Online poker has grown almost ten-fold in the past year. Its estimated annual run rate is now approaching US\$1 billion and we've only just scratched the surface. Awareness of online poker is still in its infancy - and there is a lot of room for further growth.

Fees from our poker offering continue to reflect this growth. Today, fees from poker, which have more than doubled from the first quarter of 2003, now represent 12% of our total revenue. Subsequently to the end of the first quarter, another of our major UK online casino licensees, The Ritz Club London Online, expanded into online poker using CryptoLogic-developed technology. There are now seven international gaming brands that have chosen our interactive poker software.

More recently, we released a new version of our Internet poker software with enhanced features including multi-table tournaments. We are further strengthening our hand and helping our licensees increase player traffic and multiply revenue prospects in this significant game area.

CryptoLogic's third strategic imperative is our unwavering commitment to regulatory leadership as more jurisdictions make the logical, responsible choice to move to a regulated online gaming environment. We have long distinguished ourselves by advocating the regulation of Internet gaming to the same strict standards as land-based gaming.

In fact, CryptoLogic's premier status and experience as one of the world's few software suppliers with government-approved gaming software enabled The Ritz Club London to migrate its online casino to the highly regulated jurisdiction of Alderney. Our regulatory consistency and credibility will enhance our marketability in the regulated UK market of the future.

Indeed, the UK is making rapid progress towards establishing itself as the world centre for regulated online gaming. Their goal: to enact legislation by next year. A joint Scrutiny Committee recently completed its pre-parliamentary review of the proposed Gambling Bill. The committee has urged the UK government to introduce the Bill in the current session and begin preparing for the licensing of remote gaming.

By contrast, the lack of clarity in the United States persists. No resolution is expected soon and none is on the horizon. Current prohibition initiatives remain in the Senate with not much progress to date. Most recently, this legislative uncertainty has affected advertising in the US. Certain American media organizations, including Yahoo in the US and Google have decided to take a conservative stance and no longer accept advertising for gambling-related web sites. This is precisely why we have moved steadily to diversify internationally.

So, in summary, while online gaming continues to exhibit tremendous growth prospects, we are reminded that we operate in a marketplace challenged by regulatory uncertainty, the reduction of margins from heightened competition and from increased expenditures. Therefore, we must look beyond the short term to ensure our long term future and market leadership.

To drive our long term growth and to position us as an industry leader in the growth areas of online gaming, CryptoLogic is making significant strategic investments, which are expected to reduce margins in subsequent quarters this year. These investments will enhance our poker product, increase system scalability, and enhance our gaming software infrastructure and back-office systems.

By investing wisely - and strategically - CryptoLogic can enhance our competitive advantage, grow market share in our core casino business, capitalize on the rapidly expanding game areas such as online poker, and continue to deliver attractive, profitable returns for our shareholders.

We are in excellent financial health, with the resources to make the right investments in our future and provide a positive yield through a regular quarterly dividend to our shareholders.

I shall now turn the call over to Jim Ryan, our Chief Financial Officer, to specifically address our first quarter results.

Jim Ryan: Good morning. I'm pleased to report strong quarterly performance for the first quarter of 2004. I remind you that all figures are in US dollars.

We achieved record revenue in the first quarter, which rose by 71% to \$15.2 million, compared with \$8.9 million last year. Quarterly earnings were \$0.28 per diluted share versus \$0.15 in the first quarter of 2003, and ahead of average analysts' consensus of \$0.22.

In what is one of the seasonally strongest quarters of the year, we posted record revenue growth. This performance was due to five factors:

1. The result of targeted marketing campaigns by our major licensees;
2. New licensees attaining critical mass;
3. Increased allowable player deposits limits, which resulted in higher wagering by players and an associated increase in revenue;
4. Incremental revenue from new casino games, bingo and the growing success of our poker offering; and lastly
5. Growing penetration in international markets - specifically the UK and Continental Europe.

Operating costs comprise of software development and support costs that include all personnel, licensee support, customer service, e-cash processing fees, and compliance-related expenditures. For the first quarter of 2004, operating costs increased to \$9.0 million versus \$5.6 million in Q1 of 2003.

The higher costs were consistent with planned investments in our business to support our growth objectives. Expenditures were related to new game development, increased licensee support, enhancements to our infrastructure and e-cash application.

In addition, we experienced increased processing fees associated with higher deposit levels and a growing business as well there was the added accumulated expense related to employee stock options of \$263,000.

EBITDA for the first quarter of fiscal 2004 more than doubled to \$4.6 million, compared with \$2.0 million in 2003. This translated into EBITDA margin raising to 30% as a percentage of revenue in 2004, compared with 23% in 2003.

CryptoLogic continued to deliver a track record of profitability. First quarter earnings grew 116% to \$3.8 million, or \$0.28 per diluted share, up from \$0.15 in 2003. The quarter also included a one-time insurance recovery of \$0.4 million or \$0.03 per diluted share.

The strength of our first quarter results are mirrored by the strength of our balance sheet, which provides CryptoLogic with the financial leverage to realize our growth plans. At March 31, 2004, CryptoLogic had no debt. Our cash reserves grew to \$76.0 million, or \$5.67 per diluted share. Working capital rose to \$52.4 million or \$3.91 per diluted share.

Operating cash flow in the first quarter of 2004 was \$5.1 million versus \$7.6 million last year. The amount of cash generated from operations was lower than last year due to decreased security deposit requirements in 2003 as well as reduction in licensee payables related to one licensee assuming the operation of its own e-cash.

Looking ahead, the second quarter is traditionally a solid period subject to early summer seasonality, as people tend to spend more time outdoors. Accordingly, we forecast second quarter revenue in the range of \$14.0 to \$14.5 million, with earnings of \$2.8 to \$3.0 million, or \$0.20 to \$0.22 per diluted share.

I will now turn the call back to Lewis.

Lewis Rose: Thank you, Jim. We're now pleased to open the call to questions.

Operator: Thank you. Ladies and gentlemen, we will now begin the question and answer session. To place yourself into the question queue, please press *1 on your touch-tone phone. If you are using a speakerphone, please pick up your handset before entering your request. If you would like to withdraw your request, please press *2. Please go ahead if you have any questions.

Our first question comes from Raj Karia with Canaccord Capital. Please go ahead.

Raj Karia: Good morning. Congratulations on the very good results. You talked about increased revenue coming very much from the actual growth within the industry. Do you have a number in regards to how much the online gaming industry has actually grown?

Is it possible to breakout the revenues between licensing and other revenue?

What was the average rate from your poker games that you provide your licensees?

Lewis Rose: First of all, in terms of industry growth, the analysts' expectations for industry growth in the online gaming business for 2003 were \$5.7 billion growing to \$7.5 billion in 2004. Within that sector, the poker area is expected to grow from \$600 million last year and now running at between \$900 million and \$1 billion, so a significant increase in poker. That's the answer to the first question.

The third question you asked about the revenue share from poker. The revenue share from poker in our agreements with our customers is the same as the revenue share for casinos. So the range of rates that you indicated would apply for both casino and for poker.

In terms of the second question, I'll let Jim answer that question.

Jim Ryan: Good morning, Raj. The second question, other revenues come from customization in service fees that our licensees pay. When we license our software, there is typically an up-front customization fee, which we amortize over the life of the license agreement. Those fees are approximately 3% of our first quarter revenues.

Raj Karia: Okay. Thank you very much.

Operator: Thank you. Our next question comes from Alan Lichtenberg, Lumen Capital. Please go ahead.

Alan Lichtenberg: Good morning. Could you add a little bit of colour to how much your capital expenditures might have to increase to accomplish your strategic goals in the second half?

Lewis Rose: CryptoLogic, as you may know, is a growth company and we've clearly focused on growing our cash flow and our earnings. This past quarter for example, we've just recorded record revenue and excellent profitability, so in our view, now is the time to invest in our future to maintain our growth and leadership position. So we've identified important opportunities for investment and innovation at CryptoLogic and I'll just go through them briefly with you again.

Continuing enhancement of our poker offering; increasing system scalability to accommodate the increasing volume of new additional poker players and licensees; enhancing our game software and games offering; and then further fortifying our infrastructure and increasing the capabilities of our back-office systems. So we expect that the results of these initiatives we will be spending in the order of \$6.0 million in capital expenditure for the year. And as we continue on through the balance of the year, we will continue to investigate opportunities for growth in our business.

Alan Lichtenberg: Is it possible to discuss the relative margin structure of CryptoLogic versus the competition? Are you at the very high end or something similar?

Lewis Rose: There's obviously a range of rates that competitors charge. We are in an environment now where there are over 1,800 online gaming sites, there are approximately 140 service providers and the way we approach our business is to focus on higher quality, international brand named licensees, because in our view we offer a premium product and customer responsiveness. We deliver value add and continue to be the world leader in this industry through our comprehensive suite of online gaming offerings. We have a 24/7 multi-language customer support and customer helpdesk in the UK. We have an integrated e-cash management system in three currencies and seven languages.

And more importantly than that, we offer our customer and the player a significant level of comfort by having tremendous credibility and transparency by being listed on three exchanges, the London Stock Exchange, NASDAQ, and the Toronto Stock Exchange. Our gaming software is certified in two tier-one jurisdictions - Alderney and the Isle of Man. And as a result of that, we can provide significant transparency.

As a result of these value add enhancements and the fact that we have the poker offering to attract licensees of the quality of Betfair, we believe we can charge a premium rate. And we're not going to compete purely on the basis of price. It's not the position of CryptoLogic, it's not our intention, and we've said many times we believe in the concept of "ROE", "Return on Effort". So we will focus on fewer but larger international brand name licensees as we grow CryptoLogic.

Alan Lichtenberg: Thank you.

Operator: Thank you. Your next question comes from Richard Muller with Reabourne. Please go ahead.

Richard Muller: Yes, good morning. Can you explain the decrease in security deposit requirements?

Lewis Rose: As we changed processors last year, our security deposit requirements decreased. This is the amount of money we put on deposit to provide security to the processors that CryptoLogic will be absolutely committed to meeting any obligations we have in the future. It's indeed one of our competitive advantages of having such a strong balance sheet. And as the security deposits were reduced last year, it generated cash last year. So we had an increase in cash last year as a result of the reduced security deposits. On a comparable basis, our cash flow wasn't as great. Having said that, we obviously continued to generate cash and continue to have an exceptionally strong cash position.

Alan Lichtenberg: Great, thanks.

Operator: Thank you. Your next question comes from Justin Kew of Desjardins Securities. Please go ahead.

Justin Kew: Good morning. Great results. Congratulations.

Lewis Rose: Thank you.

Justin Kew: Could you just give us an update on your progress in Asia and in terms of the use of your cash of \$76 million? Can we expect a special dividend or an increase in dividend?

Lewis Rose:

As far as Asia is concerned, we've said many times that Asia offers tremendous growth potential. We are seeing some growth and traction with our Japanese language offering. The reason that it's not as easy to break into Asia is twofold. One, there's no single popular form of payment like international credit cards and with the limited use of international credit cards, it's not as easy therefore for players to deposit money into the system. We are exploring a number of Asian payment alternatives to credit cards and we will continue to do so.

The second point is that there are a number of countries within Asia where online gaming is illegal or, for example, in Hong Kong where there is a license granted, but it's effectively a monopoly because the online gaming business has been directed towards the Hong Kong Jockey Club. So country by country, if you go through the Asian region, there aren't many countries where online gaming is A) legal, and B) have ubiquitous access to international credit cards. Having said that, our primary focus will continue to be in the UK and Continental Europe. We do believe that Japan, in particular, and Asia in general have tremendous growth potential and we will continue to focus on that area, although we have reasonable expectations on the amount of time it will take us to develop significant growth there.

As far as the cash is concerned, it is a very valid question and a question we get asked all the time. In the industry that is online gaming, trust, credibility, security, comfort are significantly important as competitive advantages. Currently we have a significant advantage in having cash on our balance sheet. It's a draw card in terms of attracting new customers, it provides assurance to players and customers alike that we're financially sound and sufficiently funded to pay players and invest in our business.

I've spoken already on this call about the importance of investing for our future and the strategic investments that we continue to make to enhance our poker product, to increase the system scalability as we take on new poker customers and also increase the volume of poker players. We will continue to enhance our gaming software, our infrastructure, and our back-office systems. The strong cash reserve enables us to do that and also ensures that we'll continue to generate cash through the process.

In addition, we will continue to consider acquisition opportunities that would strengthen our core business and/or accelerate growth in new technologies, new channels, emerging game areas, and other geographic expansion, but we will only look at opportunities that are complementary to our strategy, synergistic in value, and accretive. So all in all, we continue to look at ways to enhance shareholder value, our board meetings regularly consider various options. I'm asked all the time about share buybacks and special dividends and I can assure you that it is a topic of conversation internally. But at this point in time, we believe that we're in very good company with two other very successful entrepreneurs and business men in Warren Buffett and in Bill Gates who both have sizeable cash balances and have not shown any immediate intention of acquisitions or dividends.

Justin Kew: Understood. Thank you.

Operator: Thank you. Your next question comes from Murray Baker with Moneysmarts. Please go ahead.

Murray Baker: You mentioned earlier that you'd reduce the guidance in terms of number of new licensees per year target to 2.

Lewis Rose: That's correct.

Murray Baker: Do you foresee any coming in the near future or are there any in particular that are in the works?

Lewis Rose: We refined our strategy, we're becoming much more selective to focus on customers that will generate the highest return on efforts. We would be pleased if we signed one to two new large international brand name licensees in 2004. As you know, we've recently announced the signing of Betfair and ongoing discussions continue with other prospects. But we also believe in the concept of fish where the fish are and in our view we have a number of licensees who currently have not licensed our poker offering to their players, so we believe that if we continue to offer existing products to existing licensees we can be equally successful. For example, The Ritz Club London Online is the latest customer to add our poker offering and before that, Littlewoods. We will continue to focus on growing the business with the highest amount of return relative to the effort expended. So we will continue to focus on fewer larger

customers with the brand, the database, and the marketing might to build a strong profitable online business.

Murray Baker: With respect to the US, you'd mentioned that continues to be an area where there's considerable force trying to prohibit online gaming. Could you comment maybe on any implication in terms of the WTO ruling against the US and how that might play out?

Lewis Rose: For those of you who are not familiar with the WTO ruling, the World Trade Organization recently ruled that the US is violating global trade commitments by proposing policies aimed at banning online gaming. Now it's difficult to speculate what the real effect will be as a result of this, but we do believe that this is a very positive sign supporting a free and open market for online gaming and international cooperation.

In our view it also highlights the US restrictive stance in contrast to other governments around the world like the UK, which is moving rapidly to regulate and embrace online gaming.

Murray Baker: Thank you.

Operator: Thank you. As a reminder, ladies and gentlemen, if there are any additional questions at this time, please press *1 on your touch-tone phone.

Thank you, Mr. Lewis. There are no further questions at this time.

Lewis Rose: Thank you ladies and gentlemen. In the first quarter we demonstrated how well CryptoLogic's strategy comes together to produce rewarding results.

CryptoLogic stands for integrity and innovation. By practicing these values, focusing on our strategy and being committed to our customers - and our shareholders - CryptoLogic is achieving our business and financial targets.

I'm gratified at our success so far and excited to lead our team as we face the challenges - and seize the opportunities - as a global force in this dynamic and ever-changing industry.

I hope to see you at our annual and special meeting of shareholders tomorrow, Tuesday May 11 at 4:30 p.m. Eastern Standard Time at the Design Exchange in Toronto. If you're unable to attend the annual meeting in person, I look forward to sharing our continuing progress on our next quarterly conference call with you. Thank you.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference call. Please disconnect your lines and have a great day.