

# INTERNAL REPORT

## Churchill Downs, Inc.

July 6, 2016  
Joseph W. Garner, Stephen Amsterdam & Nathan Jones, PhD

(CHDN - NASDAQ)  
Initial Report

Current Price	\$122.63	Rating	Buy	FY16 EPS	\$5.47	Book Value/Share	\$37.09
52-week High	\$151.38	Shares Out	16.7M	EPS Growth Rate	15%	Cash/Share	\$11.57
52-week Low	\$118.98	Market Cap	2,047.8M	FY16 PE	22.5	Insider Ownership	19.1%
Price Target	\$180.00	Avg. Daily Vol	143.7K	FY16 PEG	1.9	Institution Ownership	68.6%

### Business Description

**Churchill Downs**, based in Louisville (KY), is leading casino gaming, online entertainment, and racing company that is anchored by the iconic Kentucky Derby. Specifically, Churchill Downs consists of the following segments:

- **Big Fish Games** – Churchill Downs is one of the world’s largest producers and distributors of casual games through Big Fish Games, which was acquired in December 2014. The company offers premium paid, casual free-to-play and casino-style games for PCs and mobile devices. Big Fish accounted for **34%** of total revenues and **32%** of total adjusted EBITDA in 2015.
- **Regional Casinos** – Churchill Downs owns and operates **five** casinos and **two** hotels with approximately **6,700** gaming positions. The facilities include **Oxford Casino** in Oxford, ME (*850 slot machines and 26 table games*), **Riverwalk Casino Hotel** in Vicksburg, MI (*660 slot machines, 14 table games, and a five-story, 80-room hotel*), **Harlow’s Casino Resort & Spa** in Greenville, MI (*740 slot machines, 15 table games, and a five-story, 105-room hotel*), **Calder Casino** in Miami Gardens, FL (*1,090 slot machines*), and **Fair Grounds Slots** in New Orleans, LA (*620 slot machines*). In addition, the company owns a 50% joint venture harness racetrack and video lottery terminal facility in Lebanon, OH, that includes **1,580** video lottery terminals, a racing simulcast center, and a harness racetrack. Also, Churchill Downs owns and operates **Video Services, LLC**, which has **710** video poker machines in southeast Louisiana that are located in ten of the company’s off-track betting facilities. Regional Casinos accounted for **27%** of total revenues and **32%** of total adjusted EBITDA in 2015.
- **TwinSpire** – **Twinspires.com is the largest, legal online wagering platform in the U.S.** The business is organized as an Advance Deposit Wagering business that is licensed as a multi-jurisdictional simulcasting and interactive wagering hub in the state of Oregon. In addition, The company operates **Fair Grounds Account Wagering**, an ADW business in the state of Louisiana; **Velocity**, a business licensed in the British Dependency Isle of Man focusing on high wagering-volume international customers; and **Bloodstock Research Information Services**, a data service provider for the equine industry. TwinSpire accounted for **16%** of total revenues and **15%** of total adjusted EBITDA in 2015.
- **Thoroughbred Racing** – Churchill Downs operates **three** thoroughbred racing facilities and hosts the **Kentucky Derby**, which is the longest continuously held sporting event in the U.S. The company operates thoroughbred racing operations at **Churchill Downs Racetrack** in Louisville, KY, **Arlington International Race Course** in Arlington, IL, and **Fair Grounds Race Course** in New Orleans. In addition, the company operates ten off-track betting (OTB) facilities in IL and twelve OTBs in LA. The company also owns **Calder Race Course** in Miami Gardens, FL, but ceased pari-mutuel operations in July 2014, except for certain limited operations conducted by a third party.

### Competitive Advantages

- **The Most Asset-Light Business Model in the Casino Gaming Industry** - Churchill Downs operates the most asset light business models in the gaming industry, generating nearly **50%** of its EBITDA from the asset light Big Fish social and casual gaming business and the TwinSpire online wagering platform. The table below ranks the casino gaming operators by asset intensity, as measured by EBITDA/PPP&E. **MGM Resorts International** ranks as the industry’s most asset intensive company generating only **\$0.16** of EBITDA for each dollar invested in PP&E. Churchill Downs ranks at the top of the list generating **\$0.59** in EBITDA for each dollar invested in PP&E, which is more than **2x** larger than its next closest peer.

## Asset Intensity for Casino Gaming Operators

		EBITDA 2015	PP&E 12/31/15	EBITDA/ PP&E
Churchill Downs Incorporated	CHDN	\$336	\$573	\$0.59
Boyd Gaming Corporation	BYD	\$630	\$2,225	\$0.28
Penn National Gaming, Inc.	PENN	\$796	\$2,980	\$0.27
Las Vegas Sands Corp.	LVS	\$3,955	\$15,732	\$0.25
Monarch Casino & Resort, Inc.	MCRI	\$50	\$203	\$0.25
Isle of Capri Casinos, Inc.	ISLE	\$200	\$897	\$0.22
Pinnacle Entertainment, Inc.	PNK	\$617	\$2,856	\$0.22
Caesars Entertainment Corporation	CZR	\$1,304	\$7,598	\$0.17
Wynn Resorts, Limited	WYNN	\$1,186	\$7,477	\$0.16
MGM Resorts International	MGM	\$2,239	\$15,372	\$0.15

- Owner of the Iconic Churchill Downs Racetrack and Kentucky Derby** – *Churchill Downs Racetrack* is a national historic landmark located on **147 acres** in Louisville, KY. The facility is the home of the *Kentucky Derby*, which is the longest consecutive sporting event in U.S. history, dating back to 1875. The Kentucky Derby Week events continue to grow and set records for the company, despite the ongoing secular decline of the thoroughbred racing industry. Churchill Downs’ relative success is further evidenced by the fact that the company’s racetracks hosted slightly more than **5%** of total thoroughbred horse races conducted in the U.S. in 2015, but accounted for nearly **15%** of the total U.S. wagering volume, led by the continued growth of the Kentucky Derby. We view Churchill Downs and the Kentucky Derby as iconic and irreplaceable assets that could fetch a valuation of **\$1.0 billion** or more if the company were to ever seek to monetize them.
- Big Fish Games is One of the Largest and Fastest Growing Mobile & Online Gaming Companies** – According to *App Annie*, Big Fish Games is the **fifth** highest grossing mobile publisher in the U.S. on the iOS and Android platforms combined and **19<sup>th</sup>** highest grossing worldwide. The *Big Fish Casino* also ranks as the **highest grossing casino app** on the iOS platform, according to App Annie. Social Casino is one the largest genres of mobile and online games, as *Superdata* estimates the worldwide social casino revenues market at **\$3.4 billion** in 2015. Big Fish has taken a “*social first*” approach as they are the only publisher to offer synchronous social features for slot machine games, including chatting, gifting, and friending, which results in more engaged players, higher switching costs, and strong life-time customer values. In addition, the company has expanded its game portfolio to include casual free-to-play games such as *Gummy Drop*, *Fairway Solitaire*, *Cascade*, *Dungeon Boss*, and *Sunken Secrets*, in addition to other free-to-play casino games such as *Vegas Party Slots*. The company also has the opportunity to realize revenue synergies with its regional casino business, whose customers may represent an attractive source for new customer acquisition.
- One of the Strongest Balance Sheets in the Casino Gaming Industry** – Churchill Downs is one of the most underleveraged companies in the casino gaming industry with a net debt/adjusted EBITDA ratio of **2.9x** as of March 31, 2016. The company’s asset light business model and strong cash flow has provided the company with the financial flexibility to aggressively pursue opportunities to enhance shareholder value, such as acquisitions, investments in facility enhancements and expansions, investments in new game development, debt reductions, and share repurchases.

### Assessment of Management

CHDN has a unique senior management team. CEO *William Carstanjen*, COO *William Mudd*, and CFO *Marcia Dall* all have management backgrounds with *General Electric*. The company’s chairman and Carstanjen’s predecessor at CEO, *Robert Evans* has a management background with *Caterpillar*. This is unique in the gaming industry, as most (*if not all*) senior management teams have backgrounds in the gaming industry or related industries such as lodging, real estate development, or entertainment. Management attributes this to a Board decision in the 2005-2006 timeframe to broaden and upgrade the company’s management skills after years of stagnant growth in a company that was being managed by some of the best minds in the horse racing industry. Since that time, the company has focused on the following:

- Growing the most profitable segments of its horse racing business – wagering (*especially online*) and the Kentucky Derby,
- Reducing the company’s capital footprint,
- Maximizing free cash flow,
- Expanding the regional casino business by emphasizing smaller, gambling-focused facilities with relatively little local competition and stable regulatory and tax environment. (*CHDN is not interested in capital intensive and low or no margin amenities such as entertainment facilities, hotels, spas, and restaurants and management believes it is highly unlikely that the company would ever have a presence in Las Vegas or downtown metropolitan markets*)
- Positioning the company to capitalize on the growth of online gambling and casino gaming

These moves have paid off well for shareholders, as the company has generated a CAGR of **18%** in EPS and **20%** in adjusted EBITDA with a nearly **220%** rise in the share price since 2005.

We believe that Churchill Downs has adequate corporate governance practices. The company has a highly independent Board of Directors with nine independent directors. However, we would prefer to see a non-classified Board for the company. The company also has a non-executive Chairman in Robert Evans. Insider ownership is meaningful at 19.1% of the company’s outstanding shares, which we believe aligns the interest of shareholders with insiders. Executive compensation is reasonable by industry standards and contains significant performance-based incentives.

### Growth Drivers

- **Big Fish Games** – Big Fish has proven to be a strong growth driver for Churchill Downs since the acquisition of the business in Q4-14. Big Fish generated bookings growth of **34.8%** in 2015, driven by solid performance of the Big Fish Social Casino and the surprisingly strong performance of Gummy Drop. The solid performance of the business continued into Q1-16 with bookings growing **22.3%**. Management has been actively investing in user acquisition since Q4-15, which has pressured the adjusted EBITDA margin in the near term, but should lead to stronger revenue growth and improved profitability in future periods. **We believe that Big Fish is well positioned to continue to post solid growth by expanding the customer base for its existing games, improving the monetization levels of existing games, and adding new games to the portfolio.** In addition, we believe that Big Fish significantly enhances the company’s in-house software development capabilities and expertise in online/mobile casino-based games, which could prove to be meaningful assets if and when the legalized Internet gaming markets were to expand in the U.S.
- **Regional Casinos** –Churchill Downs has focused on building a portfolio of relatively small, gambling-focused facilities with little local competition and a stable regulatory and tax environment. As a result, the company has been able to report relatively solid and consistent top and bottom line growth by driving deeper penetration of local markets and maintaining a disciplined approach to operations. Most recently, this has resulted in adjusted EBITDA growth of **7.3%** in 2015 and **12.8%** in Q1-16 with the adjusted EBITDA margin improving from **30.7%** in 2014 to **32.7%** in 2015. We believe the company has the potential to approach an adjusted EBITDA margin of **35%** in 2016. In addition to being a disciplined acquirer of regional casinos, Churchill Downs has the opportunity for new facility development pending the approval of expanded gaming legislation in Kentucky (*Churchill Downs Racetrack*), Illinois (*Arlington International Race Course*), and New York (*minority ownership position in Saratoga Casino and Raceway*). We believe that the most intriguing opportunity may be at Arlington International. The property is well located on 336 acres in the northwestern Chicago suburbs approximately 20 minutes from the Chicago O’Hare airport. There have been multiple attempts to pass legislation that would result in a casino gaming license for the facility and we expect to see additional efforts in the future as Illinois seeks to resolve a challenging state budget situation. We also believe that there are considerable real estate development opportunities for the property. We have seen estimates as high as \$1.0 million per acre, or \$336 million, for the property, indicating the inherent underlying value of the asset. **Bottom line, we see the regional casinos business as a source of solid, consistent organic growth with the potential for step function increases in both revenues and earnings driven by acquisitions, expansions of existing properties, and the development of new market opportunities.**
- **Kentucky Derby** – Churchill Downs has been successful in driving revenue growth in its Thoroughbred Racing business, despite the secular decline of the industry. Since 2010, the Thoroughbred Racing segment has grown adjusted EBITDA **70%** to **\$85 million** by more than doubling its adjusted EBITDA margin from **13%** to **29%**,

while revenues have declined **22%** to **\$249 million**. The growth in profitability has been driven by the growth of the Kentucky Derby and cost cutting initiatives. The Kentucky Derby week events continue to set new financial records for the company. Churchill Downs recently reported that the 2016 Kentucky Derby Week generated a **\$4.5 million** to **\$6.0 million** year-over-year improvement in adjusted EBITDA. This also represented an improvement of more than **\$40 million** since 2009. Attendance set a new record in 2016 at **376,980**, up **3%** y/y and total handle (*wagering activity*) rose **1%** to **\$266.8 million**. Online/mobile wagering grew even faster, rising **29%** y/y on the company's TwinSpire platform. The company has driven growth through higher attendance, higher TV viewership, higher wagering volume, more lucrative broadcast rights with *NBC*, corporate sponsorships, and enhanced amenities and offerings at the facility. **We believe that Churchill Downs is well positioned to continue to grow the Thoroughbred Racing business, despite the persistent industry headwinds, driven primarily by the success of the Kentucky Derby. However, we estimate the growth rate of adjusted EBITDA will likely moderate to the mid-single digit range over the next few years.**

- **TwinSpire** – As the industry's leading legal advance deposit wagering platform, TwinSpire has been a primary beneficiary of the secular shift in horse racing wagering activity to the Internet. Online wagering has increased from **6%** of total horse racing wagering in 2004 to **26%** in 2015. TwinSpire has been a clear market share gainer, outpacing the industry growth rate in wagering volume by **630 basis points** in 2015, **780 basis points** in 2014, and **520 basis points** in 2013. The TwinSpire segment has also generated a five-year revenue CAGR of **11%** and adjusted EBITDA CAGR of **22%**. Recent results have also been strong with adjusted EBITDA growth of **20%** on revenue growth of **9%** in Q1-16 as the adjusted EBITDA margin improved by **220 basis points** y/y to **24.5%**. We expect continued solid results in Q2-16 driven by strong performance at the 2016 Kentucky Derby where TwinSpire wagering volume grew **29%** y/y. **We estimate that TwinSpire will generate upper single digit revenue growth and low- to mid-teens adjusted EBITDA growth annually for at least the next three years.**

## Issues / Risks

The most significant risks associated with Churchill Downs shares include the following:

- The economic sensitivity of the company's business as wagering volumes, casino visitation, and social/mobile gaming monetization are sensitive to fluctuations in key economic indicators, such as consumer confidence, employment and discretionary income levels.
- The company is subject to regulatory risk associated with the approval of gaming activities in existing jurisdictions and the tax rates levied on such activities.
- The ability of the company to realize attractive and consistent returns in the Big Fish Games segment, given the uncertainty of the success of new game releases and investments in user acquisition.
- The ability of the company to continue to counteract the secular headwinds in the Thoroughbred Racing business through the growth of the Kentucky Derby, growth of TwinSpire, and cost cutting initiatives.

## Summary and Recommendation

**Churchill Downs features one of the most unique, fastest growing, and most profitable businesses in the casino gaming industry.** The company represents a play on the growth of social/mobile gaming, the secular shift of wagering activity to the Internet, the ongoing success of the iconic Kentucky Derby, and a well-managed portfolio of regional casinos. In addition, the stock offers compelling longer term growth and value realization opportunities with the potential for the approval of casino gaming operations at either Arlington International Race Course and/or Churchill Downs Racetrack, the expansion of Internet casino gaming and sports wagering, and the monetization of the company's real estate assets through some form of REIT transaction.

Despite the company's superior growth profile, profitability, and asset efficiency, the stock essentially trades in line with its regional casino industry peers at **8.5x** estimated 2016 adjusted EBITDA of **\$348 million** and **7.8x** estimated 2017 adjusted EBITDA of **\$381 million**. We continue to believe that Churchill Downs clearly deserves a premium to its peers. Our 12-month price target is **\$180 per share**, or **9x** estimated 2017 adjusted EBITDA, representing upside potential of **47%**. We rate Churchill Downs shares as a **BUY**.

## Financial Summary

CHDN	Annual Results	FY15	FY16	FY17
	Revenue	1212.3M	1323.6M	1445.7M
	EPS	3.71	5.60	6.96
	Y-Y Rev Growth	49.1%	9.3%	9.2%
	Y-Y EPS Growth	40.5%	51.0%	24.3%

FY15	3-15	6-15	9-15	12-15
Revenue	250.9M	409.2M	279.8M	272.4M
EPS	-0.09	3.10	0.24	0.43

FY16E	3-16	6-16E	9-16E	12-16E
Revenue	288.4M	435.5M	305.4M	294.1M
EPS	0.16	3.56	0.81	0.84
Y-Y Rev Growth	14.9%	6.4%	9.1%	8.0%
Y-Y EPS Growth	#N/A	14.8%	238%	95.3%

### Comments

Estimates reflect sell-side consensus

### Additional Data

Current Price	122.63
12-month High	151.38
12-month Low	118.98
FY End	12/2015
Dividend	1.15
Shares Outstanding	16.7M
Shares Short	1.1M
Avg Daily Vol	143.7K
Cash and ST Invest	104.2M
ST & LT Debt	781.8M

### Churchill Downs Incorporated (CHDN-US)



Updated: 7/6/16

Casino Gaming		FY End	Share Price	52-wk High	52-wk Low	Market Cap. (\$M)	EV (\$M)	FY2016 EBITDA	FY2017 EBITDA	FY2016 EV/EBITDA	FY2017 EV/EBITDA
Las Vegas Sands Corp.	LVS	Dec	\$42.80	\$57.23	\$36.97	\$34,014.0	\$43,067.3	\$3,870.38	\$4,249.30	11.1x	10.1x
MGM Resorts International	MGM	Dec	\$22.55	\$25.09	\$16.56	\$12,744.2	\$26,680.0	\$2,299.37	\$2,753.28	11.6x	9.7x
Wynn Resorts, Limited	WYNN	Dec	\$89.10	\$111.35	\$51.50	\$9,069.6	\$16,357.6	\$1,283.15	\$1,606.22	12.7x	10.2x
Gaming and Leisure Properties, Inc.	GLPI	Dec	\$35.06	\$36.67	\$24.82	\$7,084.6	\$9,492.1	\$701.50	\$826.59	13.5x	11.5x
Churchill Downs Incorporated	CHDN	Dec	\$122.63	\$151.38	\$118.98	\$2,047.8	\$2,960.7	\$347.75	\$380.75	8.5x	7.8x
Boyd Gaming Corporation	BYD	Dec	\$18.13	\$21.35	\$14.96	\$2,032.1	\$5,078.8	\$648.68	\$677.63	7.8x	7.5x
Penn National Gaming, Inc.	PENN	Dec	\$13.80	\$19.50	\$12.81	\$1,125.2	\$6,157.4	\$855.58	\$867.38	7.2x	7.1x
Caesars Entertainment Corporation	CZR	Dec	\$6.65	\$9.74	\$4.76	\$968.6	\$7,660.6	\$1,672.67	\$1,801.39	4.6x	4.3x
Red Rock Resorts, Inc.	RRR	Dec	\$21.77	\$22.83	\$18.64	\$902.3	\$4,577.0	\$493.76	\$548.05	9.3x	8.4x
Isle of Capri Casinos, Inc.	ISLE	Apr	\$18.35	\$20.99	\$10.92	\$747.6	\$1,588.9	\$217.24	\$223.61	7.3x	7.1x
Pinnacle Entertainment, Inc.	PNK	Dec	\$10.90	\$11.83	\$10.19	\$665.5	\$4,090.4	\$657.61	\$671.95	6.2x	6.1x
Monarch Casino & Resort, Inc.	MCRI	Dec	\$21.67	\$23.38	\$16.82	\$373.4	\$390.4	\$52.67	\$56.10	7.4x	7.0x
						\$5,981.3	\$10,675.1			8.95x	8.05x

EBITDA data for PENN is actually EBITDAR and includes \$440 million of annual rental expense under the master lease agreement with GLPI.