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Churchill Downs, Incorporated

February 10, 2014

Ticker (NASDAQ): CHDN
Price: $88.61 (Feb 8)
ICB Industry: Consumer Services

Recommendation: HOLD
Price Target: $88 - $92 (3%)
Sector: Travel & Leisure - Gambling

CHURCHILL DOWNS
INCORPORATED

ANALYSTS:

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Earnings/Share						
	Q1	**Q2**	**Q3**	**Q4**	**Year**	**P/E**
2011	(.19)	2.38	1.17	.25	3.76	13.6
2012	.08	2.82	.34	.14	3.34	20.9
2013TTM	.06	2.85	.52	.14	3.54	25.1
2014E	.20	3.25	.55	.26	4.26	20.8

Market Summary	
52 Week Price Range	$63.61-$95.33
Average Daily Volume (3 mo.)	42,491
Beta (5 Year)	1.05
Dividend Yield	0.98%
Shares Outstanding	17,980,000
Institutional Holdings	69.51%
Insider Holdings	3.94%
Cash Flow Per Share	5.90
Book Value Per Share	40.29
Return on Equity	9.10%
Shares Short (% of Float)	5.78%

Highlights

Recommendation

We recommend a HOLD rating on Churchill Downs Incorporated (CHDN). Our Discounted Cash Flow Model (DCFM) valuation suggests that the current stock price correctly values CHDN. Our analysis indicates that a combination of legalization, debt funded acquisitions, and growth could make this long shot stock a winner. We believe that a price range of $88 - $92 over a three-year investment horizon reflects the risk and fair value for this security.

Racing Industry Growth Unimpressive

The Great Recession led to significant losses and a decrease in revenue in the racing industry. While the industry has improved since the recession, racing growth has been flat (1% in 2012), or even negative when adjusted for inflation, and the long-term racing outlook is tepid.

Concentration of Revenue in Racing

CHDN's concentration of revenue in the flat or declining racing market is a significant concern. With 41% of revenue coming directly from racing operations, and an additional 25% coming from their online pari-mutuel betting service (Twin Spires), emphasis on revenue derived from racing will weigh significantly on revenue growth for years to come.

Diversification Strategy

Due to the poor growth characteristics of CHDN's core market, management has looked for expansion in other arenas, particularly acquisition of gaming operations. Of recent importance is their joint venture into Miami Valley gaming. However, growth potential is modest since they only have a 50% ownership stake. More generally, gaming growth is projected to grow 3% or less annually making acquisitions the only significant driver for revenue growth in the next 3-5 years.

Gaming Legalization in Kentucky and Illinois

One item of significant interest and potential impact on Churchill Down's ongoing operations is the possibility of legislation legalizing gaming in the Kentucky and Illinois markets. Legalization is being considered more heavily, particularly in budget-challenged Illinois, but even an immediate change in legislation would not yield meaningful revenue growth until 2016 or later.

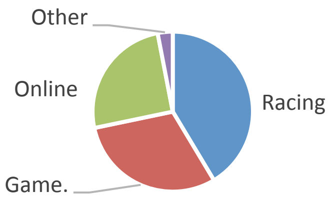
Business Description

Overview and Economic Moat

Churchill Downs Incorporated is a publicly traded, multi-state entertainment company with several racetracks including its namesake track Churchill Downs, home of the iconic twin spires and host of the Kentucky Derby, "The greatest two minutes in sports." In addition to its primary emphasis on racing, CHDN's business includes gaming and casinos, as well as the "United States' leading online wagering company" – TwinSpires online advance deposit wagering (ADW) site. To better assist our understanding of the company as a whole, its four operating segments are assessed below:

(1) Racing Operations: (41% of 2012 Revenue) includes Churchill Downs Racetrack, Arlington International Race Course and its eleven off-track betting facilities ("OTBs"), Calder Race Course, and Fair Grounds Race Course with the pari-mutuel activity generated at its twelve OTBs.

Revenue Breakdown



(2) Gaming: (30% of 2012 Revenue) includes video poker and gaming operations at Calder Casino, Fair Grounds Slots, Harlow's Casino Resort & Spa, Riverwalk Casino Hotel, Oxford Casino, and Video Services, LLC.

(3) Online Business: (25% of 2012 Revenue) includes TwinSpires, our Advance Deposit Wagering business, Fair Grounds Account Wagering, Bloodstock Research Information Services, Velocity, a business focused on high wagering volume international customers and Luckity, an ADW business that offers real-money bingo with outcomes based on and determined by pari-mutuel wagers on live horseraces, as well as the Company's equity investment in HRTV, LLC.

(4) Other Investments: (3% of 2012 Revenue, least profitable segment) which includes United Tote Company and United Tote Canada, Miami Valley Gaming & Racing, LLC, Bluff Media and the Company's other minor investments.

Although the Derby provides an economic moat through product differentiation, much of CHDN's moat comes from legal barriers to entry at the state level. Permits and licenses are limited, especially for traditional gaming, reducing competition. Online gaming is also highly regulated, but the technological nature of this industry reduces the strength of a moat. Not only is there technological change, but also it is much harder to lock out competitors (i.e. overseas and illegal online gambling). If there were to be significant legislative changes to online gaming, CHDN could simply be overpowered by larger firms, despite the niche backroom operations that create some switching costs. Overall, we assign a **weak** moat to CHDN.

Recent Strategic Acquisitions

During the past five years CHDN's management has actively and aggressively pursued a diversification strategy to expand CHDN's operations and fuel growth for the company. This diversification strategy has led to numerous casino and gaming acquisitions as well as a joint venture and media acquisition. Even though these acquisitions have fueled growth, we have significant doubts that inorganic growth alone can propel the company for a significant investment horizon beyond the next five years. The following discusses the most recent strategic acquisitions made by the company.

Oxford Casino and Riverwalk Casino Hotel Acquisitions

CHDN acquired Oxford Casino in Oxford, Maine on July 17, 2013 for approximately $168.6 million cash. This transaction included the acquisition of a 25,000-sq. foot casino with approximately 800 slot machines, 22 table games, and various dining facilities. Further, CHDN acquired Riverwalk Casino Hotel in Vicksburg, Mississippi on October 23, 2012 for approximately $145.6 million cash. The transaction included the acquisition of a 25,000-sq. foot casino, an 80 room hotel, a 5,600-sq. foot event center, and dining facilities on 22 acres of land. Both of these acquisitions were financed with borrowings from CHDN's revolving credit facility. From the date of acquisition to the end of 3Q 2013, Oxford contributed revenues of $17.7 million, and Riverwalk contributed $40.9 million for the nine months ended September 20, 2013.

Miami Valley Gaming & Racing Joint Venture

During March 2012 CHDN announced an agreement to enter into a 50% joint venture with Delaware North Companies Gaming & Entertainment Inc. (DNC) to develop a new harness racetrack and video lottery terminal gaming facility in Monroe, Ohio. The joint venture agreement formed the new company, Miami Valley Gaming & Racing LLC (MVG). CHDN and DNC will contribute up to $220 million in equity contributions to MVG. The new MVG facility opened in December 2013 including a 5/8 mile harness racing track, an 186,000-sq. foot gaming facility, and approximately 1,600 video lottery terminals. During the nine months ended September 30, 2013, CHDN had funded $27.0 million in capital contributions to the joint venture. The current financial prospects and implications for CHDN in relation to the joint venture are difficult to project, but the probability of specific financial results are addressed in the valuation section of this report.

Management

Robert Evans serves as the Chairman and CEO of CHDN, a position he has held within the company since August of 2006. Prior to his role at CHDN, Evans held senior executive positions at a number of North American companies, including Caterpillar Inc., Mazda Motors of America Inc., Aspect Development Inc., and Accenture Ltd. Additionally, COO William Carstanjen was also promoted to President in the company in 2011 and has previous experience as COO of CHDN and an executive with GE. The rest of the CHDN executive management team consists of Executive Vice President and CFO William Mudd, and Executive Vice President Alan K. Tse, a relative newcomer who joined the team in 2011.

With broad experience, but relatively new to CHDN, management is looking to continue the diversification strategies long underway at CHDN's competitors. The management team has demonstrated competence in the past, boosting revenue through strategic acquisitions, leading to a better stock price and stronger ratios, such as operating margin and return on equity, than their competitors. However, industry-wide headwinds and recent financial decisions to take on more expensive unsecured debt call into question management's ability to facilitate further stock appreciation.

Potential Gaming Legislation

Kentucky Gaming Expansion

The Kentucky legislative session began in January 2014 with alternative gaming as a major topic. The *Kentucky Wins!* organization was created by a group of business leaders to change and enhance the debate on expanded gaming in the Commonwealth. It was launched in October 2013 and has continued to build momentum heading into the 2014 legislative session. The General Assembly could authorize the installation and licensing of slot machines and table games in the state's horse racetracks. Governor Steve Beshear supports casinos, and neighboring states – particularly Ohio – allow them. In the past these efforts have failed because of horse industry infighting and reluctance by conservative lawmakers who worry about the impact of expanded gambling on families. Additionally, many citizens in the Commonwealth harbor the belief that if casinos stand to make billions of dollars, then Kentuckians are losing billions of dollars, which provides poor sentiment for gaming. If an amendment could pass (which would require 60% approval in both the House and Senate) in 2014, it would be voted on by the public in November 2014. However, the passing of an amendment that quickly is unlikely because topics such as pension reform and K-12 education funding are leading the legislative debate. An impact on CHDN's revenue growth in the next 3 years is doubtful. In fact, if a bill were to make it through a passing vote by the public in late 2014, the time frame to install new slot machines at Churchill Downs would likely be staggered, with CHDN failing to recognize any meaningful impact to revenue from this legislation until around 2016.

Illinois Gaming Expansion

The state of Illinois has also seen potential for expanded gaming legislation with Senate Bill 1739 which is pending in the Illinois House and is expected to see action during the 2014 legislative session. This bill can garner more attention now that Illinois' Governor Quinn and legislative leaders have come to an agreement over pension reform, which was holding up other potential bills' progress. SB 1739 would allow for 5 new casinos, including one in Chicago, and permit slot machines at racetracks, such as CHDN's Arlington Park in a suburb of Chicago (allowing the installation of 1,200 slots there). Again, the surrounding debate over strict regulatory oversight and ethical standards as proposed by Governor Quinn for the 'racinos' and Chicago casino continue to cast uncertainty over this potential expansion. However, Illinois' governor has softened his position on gaming in the state, and overwhelming budget problems provide an incentive to pass a pro-gaming bill quickly. We foresee a greater likelihood of positive outcome from this bill for CHDN than in the Kentucky case, but the impact may occur in a similar time frame because the bill concerns a similar implementation process with slot machines. Therefore, recognition of meaningful growth may not be expressed until

2016 as well. Specific probabilities for either bill passing (in KY or IL) with the subsequent impact on revenues are addressed further in the valuation section of this report.

Industry Overview

The gambling industry is highly dependent on discretionary spending and consumer income growth. Due to this relationship, operating income can experience large swings in a changing macroeconomic environment. The capital intensive nature of the industry means that cash flow is crucial for meeting debt requirements, and a substantial dip in cash flow will increase the significance of debt interest and maturity obligations. In the event of an economic downturn management may be required to lay off employees or sell assets in order to increase cash flow, leaving little cash for development programs. However, during times of increased consumer spending the gaming industry benefits, allowing management to focus on expansion projects and service development. Due to the cyclical nature of the economy, gaming companies like CHDN must not take on too much leverage to remain nimble enough to avoid problems meeting debt obligations. The industry's cyclicality also tends to foster single-digit P/E ratios.

Regulation

Horseracing is a highly regulated industry. In the U.S., individual states control the operations of racetracks within their jurisdiction in order to promote fairness, generate tax revenue, licensing, and preventing organized crime from being involved in the industry. These regulations differ from state to state but generally speaking the overseeing body determines the amount of live race days and the licensing requirements. Substantial changes in the amount of live racing days will have impact on operating earnings in future years. This is a potential issue for CHDN, because a large number of live race days at its racetracks enable the company to earn more revenue through pari-mutuel handle. The recent uncertainty surrounding Arlington's total number of live race days for 2014 (in comparison to 2013) illustrates the complexity and risks involved in securing the total number of race days per year for a track.

Regulation in gaming is equally comprehensive. Gaming is supervised on a state level by an oversight board usually responsible for maintaining fair and trustworthy gaming venues, cash reserve requirements, licensing and tax revenue, and the establishment and maintenance of responsible accounting procedures. This industry is monitored very closely and failure to comply with regulations may have an adverse effect on the business.

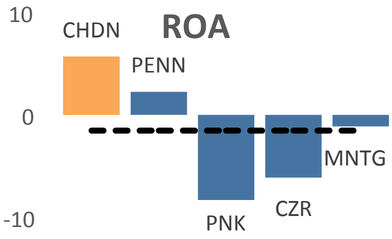
Legislation

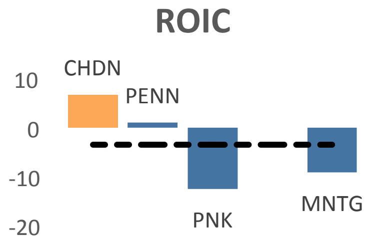
There are two pieces of legislation that, if passed, could provide expanded gaming in Kentucky and Illinois. In Kentucky, House Bill 443 would provide up to seven casino locations and would create an Equine Excellence Fund, into which ten percent of gaming revenues would be directed. The purpose of the fund is to attract horseman with higher purses, improved racing venues, and marketing for the equine industry. The fund is also designed to stifle concerns that expanded gaming will harm the equine industry by diverting consumers from racetrack to casinos. See Potential Gaming Legislation section for more information.

Illinois' expanded gaming initiatives seem a bit closer to realization than its Kentucky counterpart. Senate Bill 1739 won approval in the Illinois Senate and is currently pending the approval of the Illinois House of Representatives. This legislation will provide casino gaming to Illinois racetracks and add five additional casinos within the state. Currently, legislators are concerned that the gaming may already saturate much of Illinois, and new casinos would only create more churn.

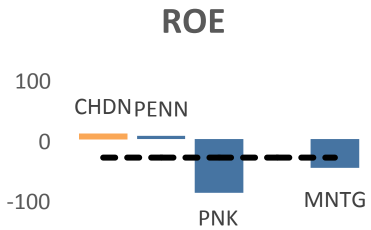
Competitive Positioning

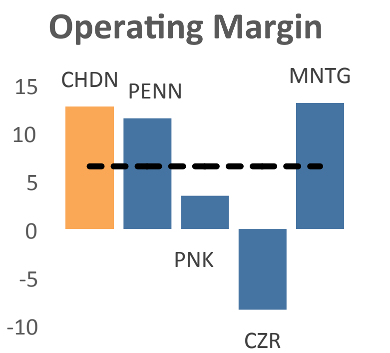
CHDN's major competitors are: Caesars Entertainment Corp (CZR), Pinnacle Entertainment Inc. (PNK), and Penn National Gaming Inc. (PENN). CZR's operates many casinos across the country, some within close proximity to CHDN properties or racetracks. Due to CZR's scale and multiple locations, it is a true threat in the competition for market share. PNK started solely as a racetrack operator and has been diversifying by acquiring casinos as early as 1996. PNK now owns and operates 18 casinos and two racetracks. PENN also has its roots in horseracing, and purchased its first casino in 2003. PENN now operates 18 casinos, 7 'racinos', and 7 racetracks.

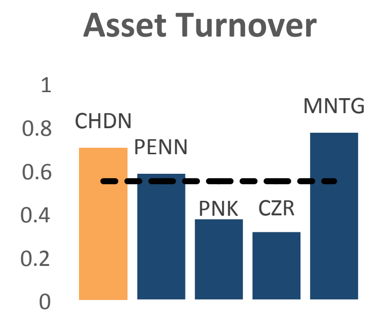




P/E TTM	25.1	P/B	2.2
P/S	2.0	P/CF	10.1







The declining popularity of horseracing has been no secret. Even prestigious venues such as Churchill Downs racetrack, the Aqueduct, and Belmont Park are experiencing substantial decline in revenues from racing operations. Proper diversification away from racing is essential for growth. CHDN acquired its first casino in 2010 and has continued to maintain an aggressive diversification strategy, and the company has steadily grown through the acquisitions. But organic growth over the past five years has been tepid.

Relative Profitability

CHDN's return on assets (ROA) and operating margin (OM) is well above its main competitors even with the substantial increase in total assets over the past few years. The results may be attributed to the growth the company has experienced in the online segment of their business, which boasts larger margins than other segments.

Valuations ratios

Using the standard metrics, CHDN appears to be a bit over stretched when compared to the industry before considering future acquisitions. CHDN has relatively high forward Price/Earnings and Price/Sales ratios. It also has a relatively high Price/ Tangible Book Value ratio. This is due to the large amount of M&A activity seen by the company in recent years. Even yet, CHDN has managed to maintain an attractive debt/equity ratio compared to the industry, leaving us to question the possibility of M&A projects in the near future. Its diversification strategy has yielded good results in a short period of time and has pushed its price multiples higher than market peers.

Dividend Yield

In 2011, CHDN decided to increase its dividend for the first time in recent history. The current dividend yield is about 1 percent, which is unusual in this industry, as CHDN's core competitors do not offer dividends to its investors. By returning value back to investors CHDN has been able to show strength in a space that was hit hard by the most recent recession. Continued growth in the dividend yield is expected as the company continues to become a more diversified provider of gaming and horseracing venues.

Financial Analysis

CHDN has implemented a diversification strategy that has shifted its focus towards its gaming and online segments. Recent acquisitions in these areas have resulted in impressive growth and, though the Kentucky Derby and Kentucky Oaks still draw huge crowds and profits, the pivot from horse racing appears to be out of necessity – the horse racing industry is in a slow decline. The online and gaming sectors have attractive economics and growth opportunities, while horseracing does not.

Profitability

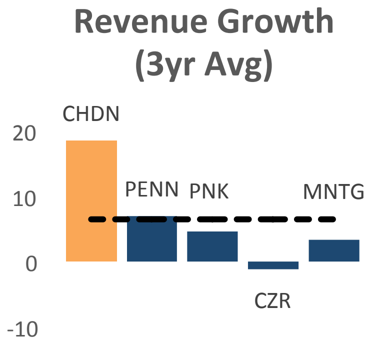
In 2011, after the Calder, Youbet, and Harlow acquisitions had time to be implemented, noticeable changes started taking place. Net Margins, Return on Invested Capital (ROIC), Return on Equity (ROE), and Return on Assets (ROA) all more than tripled from 2010 to 2011, and have since modestly decreased and leveled off. These figures reflect the success of the diversification strategy. For the future, it is important to note that 68 percent of all wagers are not placed on the track or online but somewhere else (OTBs, dog tracks, etc.) CHDN wishes to move existing gamblers from 'somewhere else' to their gambling website and believes the proliferation of technology has been strong enough to support this move across all generations.

Efficiency

Over the past 9 years CHDN has maintained a fairly stable Asset Turnover Ratio (ATR) of around .70. This is slightly above the average mark among its competitors. Fixed Asset Turnover has modestly increased over the past 9 years. This is likely due to the selling of stagnant or negative revenue growth of certain racetracks and the acquisition of the more profitable gaming and online facilities. CHDN's ATR should remain level and above industry averages for the foreseeable future.

Liquidity

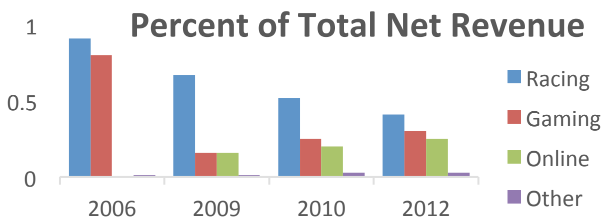
Starting in 2008, the growth through diversification strategy has allowed CHDN to overcome difficult challenges posed by a declining horse racing industry and a difficult economy. There have been over a half dozen acquisitions to help CHDN hit record highs in revenue. Lower cash reserves have been a trend over the past 5 years as CHDN has been expanding through these acquisitions. The Current



Ratio and Debt to Equity Ratio are near 10-year averages as management has handled acquisitions well. CHDN also boasts a Debt to Equity ratio better than all of its peers.

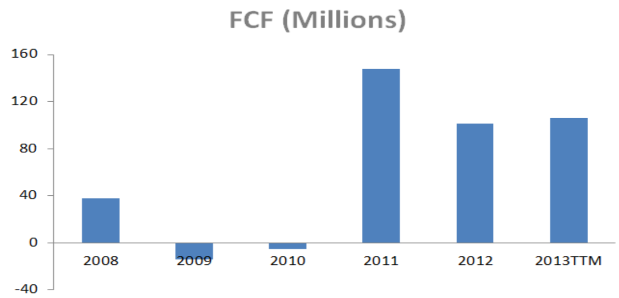
Earnings and Revenue

Diversification has translated into impressive bottom-line results, allowing CHDN to remain financially strong. We believe the growth through diversification strategy to be a smart and successful one, and we acknowledge that there may be continued growth in this fashion through the gaming and online segments. However we believe organic growth will not be able to sustain these results and the attractive earnings and revenue growth rates propped up by acquisitions may hide a deeper, fundamental shortfall in CHDN's ability to grow organically. Nonetheless, earnings and revenue growth rates have been very strong over the past several years, especially in the online and gaming segments. CHDN far outpaces competitors who continue to struggle to find organic growth and have reported multiple years of negative revenue growth.



Cash Flow

Yet another benefit to the diversification strategy has been the drastic improvement of Operating Cash Flows and Free Cash Flows. Free Cash flow has grown from -$5 million in 2010 to $148 in 2011. This number has leveled off just above $100 million for the trailing twelve months, nearly $120 million more than the pre-2011 8 year average. Operating Cash flow has seen similar gains in the same time period, growing $113 million from 2010 to 2011. This influx of cash has prompted management to raise dividends 44% since 2010.

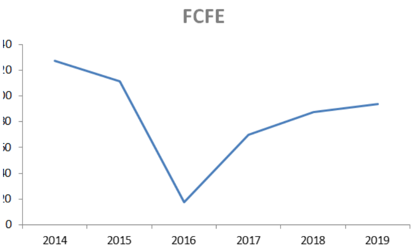


Valuation

Fair valuation estimate ($88-92)

Discounted Cash Flow: FCFE

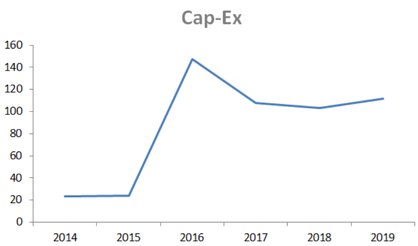
The Free Cash Flow to Equity (FCFE) model uses previously stated Financial Analysis assumptions to project future cash flows and discount them back to the present. The FCFE model was used because of the significant likelihood of acquisitions in CHDN's near future. Much of the FCF to the firm will likely be used in acquisitions and be unavailable to shareholders. In our model, our explicit projections cover from Q3 2013 to 2019. The DCF model relied upon many variables, but some of the major factors are the WACC, expectations for debt financed growth, operating margins, fixed asset to sales ratios, and perpetual growth rates for each business segment. The model was constructed by projecting revenue growth and margins for each of the five business segments. Our explicit predictions are followed by straight lining to industry average based terminal values. Model balance sheets were generated using fixed asset to sales ratios (which have been consistently declining due to recent acquisitions). We then discounted the future cash flows to the present, added in cash and cash equivalents, and subtracted the current market value of debt.



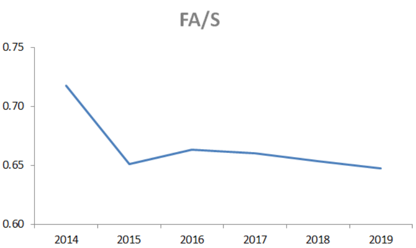
We expect FCFE to be bumpy over the next several years because of significant acquisitions or expansions in the gaming segment based on the issuance of $300 million debt in December, CHDN's strong balance sheet, and recent history. However, the strength caused by switching the segment mix towards higher growth and higher margin segments will provide good prospects for the firm in the medium to long term. We expect the firm to be primarily driven by gaming revenues within the next 3 years with online revenues surpassing racing revenues within 5 years. The changes to the business model were the focus of our projections.

Debt and Capital Expenditures

The cost of debt was projected using a weighted average of historical and recently issued debt. Depending on the portion of the new issuance used to pay down existing debt, r_d was calculated as likely near 3.60% currently, but will likely move upward as debt is repaid and as more debt is issued at higher interest (rates slowly return to a normal environment). Inputs for r_d range between 3.6% and 7.0% due to the changes in capital structures expected within each scenario to be discussed below and rising interest rates in general. We did not find that reasonable changes in interest rates led to a significant change in the valuation. Long term, we expect half to two thirds of CHDN's debt to be retired in 2021.

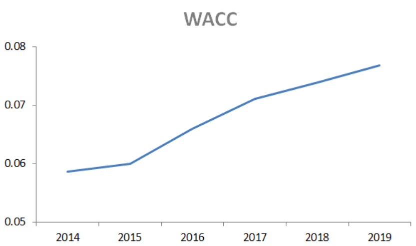


Capital expenditures are critical to our model. The base case is shown to the left. To find the required future capital expenditures we took the difference between fixed assets at cost on our general balance sheets. Because of the relatively asset light nature of the online business (as opposed to racing and gaming), we set fixed assets relative to sales less online sales at .90. Over time this causes FA/S to decrease over time from a ratio near .72 to an average of .63. This puts the firm more in line with other gaming/ casino peers who have an average near .58. CHDN ends the model at .59.



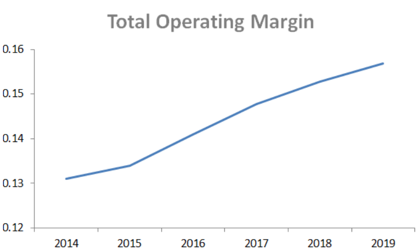
Weighted Average Cost of Capital

Using the security market line with a beta of .95 we found CHDN's cost of equity to be between 6.8% and 9.9% over the life of our model. Much of the increase was caused by the normalization of the risk free rate. For return on equity, although a two-year regression gave us a beta of .85, we relevered the beta to account for increased debt in the capital structure in each scenario. We also adjusted the beta in later years to reflect the tendency to revert to the mean. By using the cost of debt information given above and our cost of equity we found a weighted average cost of capital between 5.9% and 8.6% for the years in question because of the changes in capital structure for the firm. A 36.5% tax rate was used in our analysis, a weighted average between the last 5 years and the current year.



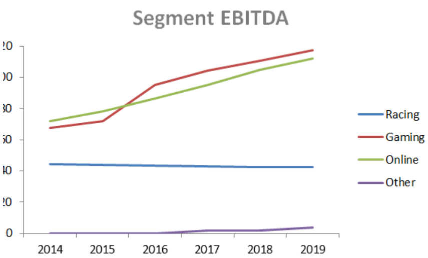
Operating Margins

We projected horseracing margins for the next 6 years near 15% (current levels) with a long-term margin of 13.5% (a five year average) due to the declining nature of the industry. We doubt the recent, slight growth in margins will be sustainable beyond the next few years, although margins for the Derby will remain strong. Margins for the other segments were based on a combination of industry averages and the limited history of each segment with the firm. The more profitable gaming segment has margins of between 25% and 26% in our model. The most profitable segment, online, has projected margins of 33% to 36% and is a significant source of value for the firm. Because of the largely fixed costs and revenue growth, margins have been steadily increasing for the online segment. We projected that within the next five years the other portion of the business would begin to be profitable with margins approximately those of the racing industry. However, given the small portion of the business in other, this change is not expected to have a significant effect on the value of the firm.



Industry & Perpetual Growth Rates

The racing industry has been steadily declining for many years. We used a -1% growth rate in perpetuity to continue this trend. By evaluating horse racing growth under several more optimistic scenarios we found potential prices between $92.64 and $90.50. For gaming, although the industry average growth rate has been steady with GDP over the last 20 years (3%) because of the long term potential for growth due to legalization (especially in KY and IL) we placed long term gaming growth for CHDN at 4%. Similarly, following strong but normalizing growth in the last three years we believe that the online segment can grow at a stronger 4.5% long term, as there is likely to be a staggered (state by state) trend of legalization for online gaming like there has been for alcohol since prohibition. However, online gaming will likely detract from traditional gaming over time, just as off-site betting has eroded racing revenues. The downside of having traditional and online gaming similarly weighted in CHDN's portfolio is that gains from substitution will be largely limited to the



increase in margins. For the next five years we expect online gaming growth to step down from 8% to 6.5% annually, as Q3 2013's year over year online growth was only 6.5%. The online segment grew 11% and 36% in 2012 and 2011, respectively. For the last segment, we expect other revenue to grow at a modest 3% long term. The diverse portfolio of often racing related projects should not grow faster than gaming in general and only makes up a small portion of the firm. The projected segment EBITDA shows the expected combination of growth and margins.

Sensitivity (See Appendix)

We used a scenario analysis based on the likelihood of legalization of gambling in Kentucky and Illinois, or other significant acquisitions in the gaming segment. In addition to the strong organic growth seen in CHDN's gaming segment, we believe it is very possible there will be much more growth in the near future (either through acquisitions or legalization). In this analysis each new casino would be approximately the same size and cost of other casino's operated by the firm ($150m-$180m) purchase. One purchase would cause a 25% increase in gaming revenue and 50% for two within the next five years to be combined with organic growth. See Appendix. One purchase leads to compound gaming revenue growth of 12% annually. Based on a 40% probability of legalization in Illinois and a 33% probability of legalization in KY[1], the combinations of single, multiple, and no legalizations led to a weighted average price of $87.89. The strong possibility of neither state legalizing ($81.70) weighed on the average, while a $92.72 price was found with both states legalizing gambling or, equivalently, two gaming acquisitions.

We also tested sensitivity to slowing online gaming growth and margins. A 3% long term growth rate for online gaming leads to a $79.64 fair value, while a 7.7% long term compound annual growth rate is needed to give the stock a 20% margin of safety. Any future decrease in online margins from current levels would be detrimental to the valuation, leading to a valuation in the low $80's.

Strengths
- Diversification
- Expertise in horseracing

Weaknesses
- Inorganic growth through M&A

Opportunities
- Potential KY and IL gaming legislation
- Online business

Threats
- Decline of interest in horseracing
- Successful online gaming competitors

SWOT Analysis

Strengths

The recent development of a cohesive diversification strategy by CHDN management has greatly propelled CHDN's revenue growth. Further, CHDN's expertise in the horseracing industry due to the Kentucky Derby and the Kentucky Oaks at Churchill Downs has helped the company extract a lot of value from its horseracing operations.

Weaknesses

Inorganic growth through strategic acquisitions has been CHDN's greatest weakness. Even though the company has been able to grow significantly as a whole over the past 5 years, it has mainly been due to bolt-on acquisitions of casino operations (which are becoming an ever-growing portion of the company's overall business at 31% of net revenues). Organic growth of traditional operations has been slow, or even negative, over that same time period.

Opportunities

Recent potential legislation changes in both Illinois and Kentucky provide significant opportunities for CHDN, if they ever come to pass. Further, the company's Online Business has been growing at a very high rate, providing CHDN with a potential avenue for more revenue growth.

Threats

The continuing decline of interest in horseracing will plague CHDN going forward, as this segment of the company provides a significant portion of its revenue (41%) with a heavy reliance on the second fiscal quarter. Further, more successful online gaming sites will threaten the continued growth of CHDN's online gaming business.

Investment Risks

CHDN faces significant risks related to its entertainment, gaming, and racing operations. These risks can significantly impact the future performance of the company, and the following investment risks support our HOLD rating.

[1] J. Thomison, Industry Mentor with Hilliard Lyons, personal communication, January, 21 2014.

The economic conditions related to horseracing are unfavorable

Horseracing and related activities, as well as gaming services, are similar to many other leisure activities in that they represent discretionary expenditures likely to decline during economic downturns. In some instances, even the perception of an impending economic downturn or the continuation of a recessionary climate can be enough to discourage consumers from spending on leisure activities. These economic trends can impact the financial viability of other industry constituents, making collection of amounts owed to CHDN uncertain. For example, during the year ended December 31, 2010, CHDN recognized $1.1 million of bad debt expense, net of purses, resulting from the bankruptcy filing of New York Off-Track Betting Corporation. Further, during tight economic conditions, consumers who would be more likely to participate in CHDN's racing and gaming operations may be unwilling to sacrifice their limited discretionary income on betting activities. Even though the United States is in a recovery period following the 2008-09 financial crisis, we still find the economic conditions unfavorable for horseracing activities, leading to a decline in both tender activity and total revenue growth. While the Kentucky Derby and Kentucky Oaks provide excellent earnings potential during Q2 of each year, unfavorable horseracing conditions create significant risks for CHDN's other racing operations in the US throughout the year.

Racing business faces significant competition, expecting to increase

All of CHDN's racetracks face competition from a variety of sources, including spectator sports and other entertainment and gaming options. Competitive gaming activities include traditional and Native American casinos, video lottery terminals, state-sponsored lotteries and other forms of legalized and non-legalized gaming in the U.S. Further, all of CHDN's racetracks face competition in the simulcast market.

Approximately 46,000 thoroughbred horse races are conducted annually in the United States. Of these races, CHDN hosts approximately 4,000 races each year, accounting for approximately nine percent of the total. CHDN competes for wagering dollars in the simulcast market with other racetracks conducting races at or near the same time as CHDN. It also competes with other racetracks running live meets at or near the same time as CHDN's races. In recent years, this competition has increased as more states have allowed additional, automated gaming activities, such as slot machines, at racetracks with mandatory purse contributions. The increased gaming possibilities in other states have led to a decrease in horseracing interest in areas where CHDN operates.

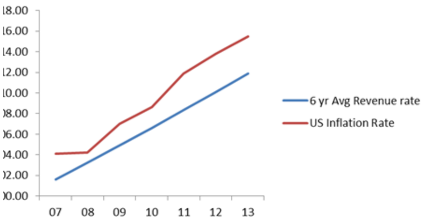
The popularity of horse racing is steadily declining

There has been a general decline in the number of people attending and wagering on live horse races in North American racetracks due to a number of factors, including increased competition from other wagering and entertainment alternatives as discussed above. There has been recent favorable gaming legislation by neighboring states from which CHDN competes for pari-mutuel wagering dollars. Pari-mutuel handle in the U.S. declined 7.3% between 2010 and 2009, declined 5.7% between 2011 and 2010, and remained fairly flat during 2012, increasing 1.0% compared to the same period in 2011. We find this five-year decline to prove a very significant investment risk for CHDN. Even though we believe the Kentucky Derby and Kentucky Oaks will continue to fair very well in the coming years, the decline in horseracing interest across the country could significantly dampen operations for CHDN in other horseracing markets. According to CHDN's 2012 10-K Churchill Downs brought in approximately 26% of net pari-mutuel revenues (a trend occurring over the past three years) while operating only 15.5% of the live racing days. This disparity reveals the importance of Churchill Downs to CHDN's racing operations, while also indicating its resiliency as a top racing venue for betting. Calder continues to operate the most live racing days (~150) but has witnessed trending downward revenues of (10%). The lower interest in racing may further have a negative impact on revenues and profitability in the racing business, as well as the ADW business, which is dependent on racing content provided by the racing business and other track operators. A continued decrease in attendance at live events and in on-track wagering, or a continued generalized decline in interest in racing, could have a material, adverse impact on CHDN's operations and financial results, specifically their revenue growth in the horseracing segment.

Will recent debt issuance be used for growth?

Throughout the past five years CHDN has operated with a strong balance sheet and consistent positive cash flow that has been reinvested into operations. However, with the more recent diversification strategy management has implemented (over the previous fiscal years), CHDN has needed to take on more and more debt to finance strategic acquisitions. On December 16, 2013, CHDN completed the issuance of $300 million in 5.375% senior notes due in 2021. These notes are senior unsecured obligations guaranteed by CHDN's domestic subsidiary properties and operations. We foresee CHDN using the proceeds from this issuance to repay "portions" of its outstanding borrowings and accrued unpaid interest on other credit facilities as described in the press release. CHDN did not mention strategic acquisitions, but we believe they are possible considering size of the previous debt relative to the bond offering. Why repay debt with debt at a significantly higher interest rate? Diversification through M&A activity may be slowing for the company due to the indication above concerning the debt issuance.

Derby Revenue Growth vs. Inflation



Derby Week accounts for a significant portion of revenue

Of particular importance is the seasonality in CHDN's business. In the 2nd quarter CHDN typically earns approximately the same amount of revenue as is earned in the other 3 quarters. One big driver for this phenomenon is "derby week": when the company's namesake track hosts both the Kentucky Oaks and the Kentucky Derby. Due to the reliance of CHDN's business on this quarter, this concentration of revenue earnings represents a significant investment risk if Derby Week suffers. However, the name recognition of such a marquee event helps to protect CHDN's competitive advantage concerning market share of operations related to Derby Week.

Investment Summary

While our analysis of CHDN acknowledges the recent successes the firm has seen through management's aggressive M&A activity and diversification strategy, the current stock price demands a premium out of investors' money that we do not believe CHDN can command.

Continuing Decline in the Popularity of Horse Racing

The horse racing industry' popularity has been on a constant decline for several decades. In fact, within the past five years, the industry has witnessed significant declines in pari-mutuel handle as indicated by the discussion above. CHDN relies heavily on this industry for earnings consistency, and the unfavorable outlook for the future of horse racing provides little incentive to pay a premium for this stock.

Potential Gaming Legislation

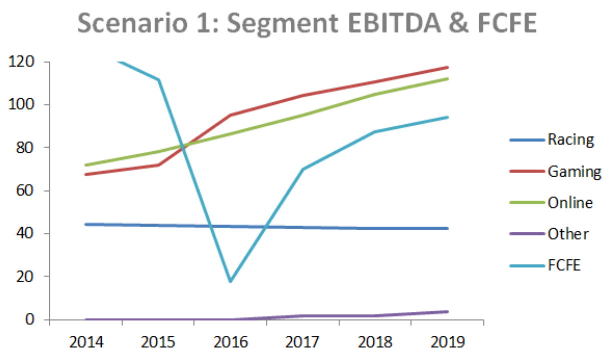
The possibility of gaming expansion in both the states of Illinois and Kentucky provide some hope for CHDN's stock growth in the future, but the unlikelihood of any near term changes in legislation disavows a reliance on these projections. An analysis of the probabilities of such occurrences was discussed above in the valuation section. And even when accounting for the possibility of gaming expansion in these two states, CHDN still would only hope to receive a minor boost in its valuation. Therefore, we do not find the prospects of "potential" legislation a solid enough reason to buy at the current stock price.

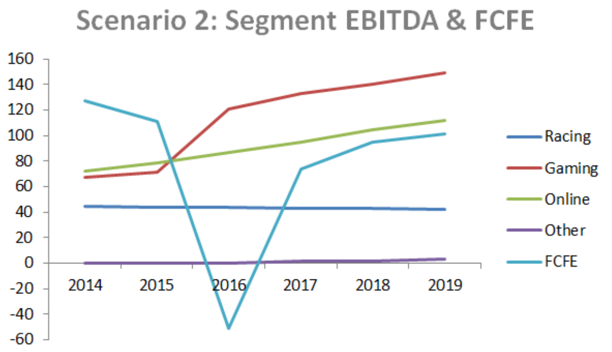
Stock Trading at Fair Valuation

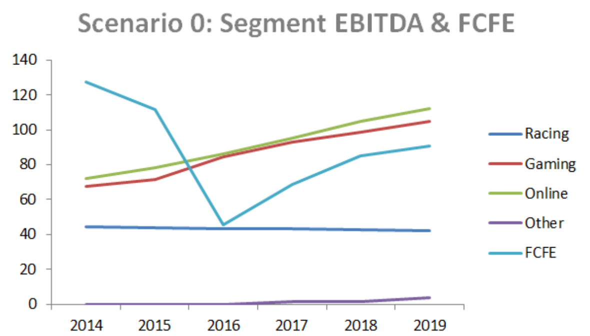
Great companies do not always make great stock picks. This has been true in the past and it will continue to be true in the future. As a value investor seeking to purchase the stocks of good, strong companies with excellent management, one must continually be on the lookout for stocks trading below fair valuation. Based on our valuation model, we find CHDN to be trading near its fair value of $88-92. Therefore, we recommend a HOLD rating. A combination of legalization, acquisitions, and growth could make this long shot stock a winner.

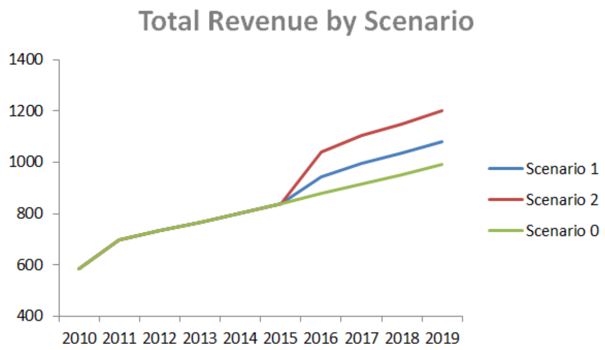
Appendix

Scenario Analysis Weighted Average $87.89
Scenario 1: 1 Gaming Expansion ($91.82: 46.7%)
Scenario 2: 2 Gaming Expansions ($92.70: 13.3%)
Scenario 0: 0 Gaming Expansions/ Small Purchase ($81.7: 40.0%)
All numbers below in millions.









Valuation Model

Basic Assumptions and Calculations

Firm	CHDN					
Year	2014	2015	2016	2017	2018	2019
N	1	2	3	4	5	6
Beta	0.94	0.94	0.94	0.94	0.94	0.94
P/E Target	20					
Imp Div Adj	1					
Rf	0.0016	0.0033	0.0083	0.0115	0.0151	0.0186
MRP	0.0700	0.0700	0.0700	0.0700	0.0700	0.0700
k	0.0672	0.0689	0.0739	0.0771	0.0807	0.0842

DCF Model		
	#Shares	17.98
81.70	MktPrice	88.40
-8.20%	MktCap(B)	1589
	Rf	0.0050
	MRP	0.0700
	k	0.0689

	0.24159574					
D	384	Rd	0.0470	teff	0.36	
E	1589	Re	0.0706	V	1,973	
Other current assets/Sales	16.00%	16	Min Cash	4.00%		4
Current liabilities/Sales	25.00%	25				
Net fixed assets/(SalesXonline)	90.00%	90				
Other LTA/Sales	70.00%	70				
Depreciation rate	6.42%	6.24				
Interest rate on debt	4.70%	10				
Interest paid on cash and marketable securities	0.50%	8				

Rd	0.03600	0.03600	0.03600	0.05000	0.05000	0.05000
Debt	384	384	549	549	549	549
Re=k	0.0672	0.0689	0.0739	0.0771	0.0807	0.0842
WACC	0.0586	0.0600	0.0659	0.0710	0.0739	0.0767
Segments						
racing	-0.0100	-0.0100	-0.0100	-0.0100	-0.0100	-0.0100
gaming	0.0600	0.3250	0.1000	0.0600	0.0600	0.0600
online	0.0900	0.0700	0.0700	0.0700	0.0700	0.0700
other	0.0500	0.0500	0.0500	0.0400	0.0300	0.0300
Revg	0.0497	0.0420	0.1253	0.0563	0.0418	0.0426
Revenue	803	837	942	995	1036	1080
racing	296	293	290	287	284	282
gaming	260	276	366	402	426	452
online	218	237	254	272	291	311
other	29	30	32	33	35	36

Income Statement Projections—Net Income Valuation Calculation

SGA	0.0980	0.0980	0.0980	0.0980	0.0980	0.0980
Other	-0.0050	-0.0050	-0.0050	-0.0050	-0.0050	-0.0050
Margins						
mracing	0.1500	0.1500	0.1500	0.1500	0.1500	0.1500
mgaming	0.2600	0.2600	0.2600	0.2600	0.2600	0.2600
monline	0.3300	0.3300	0.3400	0.3500	0.3600	0.3600
mother	0.0000	0.0000	0.0000	0.0500	0.0500	0.1000
AvgMargin	0.1311	0.1339	0.1409	0.1477	0.1528	0.1568
mCapex/Capex	0.2500	0.2500	1.0000	1.0000	1.0000	1.0000
	0.131	0.134	0.141	0.148	0.153	0.157
Rev	803	837	942	995	1036	1080
racing costs	252	249	247	244	242	239
gaming costs	193	204	270	298	315	334
online costs	146	159	168	177	186	199
other costs	29	30	32	32	33	32
SGA	79	82	92	97	102	106
Depreciation	**61**	**62**	**68**	**76**	**83**	**90**
Opincome	105	112	133	147	158	169
IntExp	21	21	17	27	27	27
Other	-4	-4	-5	-5	-5	-5
EBT	89	95	121	124	136	147
Taxes	32	34	43	45	49	53
NI	57	61	77	80	87	94

Balance Sheet Projections

Firm	CHDN						
Year	2014	2015	2016	2017		2018	2019
N	1	2	3	4		5	6
Balance sheet adjusted	TRUE	TRUE	TRUE	TRUE	TRUE		TRUE
Cash and marketable securities	44	700	871	924		994	1,070
Other current assets	104	134	151	159		166	173
Fixed assets							
At cost	950	981	1,128	1,236		1,340	1,451
Depreciation	374	436	504	580		662	752
Net fixed assets	576	545	625	657		677	699
Other LT Assets	564	586	659	696		725	756
Total assets	1,288	1,378	1,647	1,740		1,837	1,942
Current liabilities	180	209	235	249		259	270
Debt	384	384	549	549		549	549
Stock	294	294	294	294		294	294
Accumulated retained earnings	430	491	568	648		735	829
Total liabilities and equity	1,288	1,378	1,647	1,740		1,837	1,942
FA/S	0.72	0.65	0.66	0.66		0.65	0.65
Free cash flow calculation							
Profit after tax	57	61	77	80		87	94
Add back depreciation	61	62	68	76		83	90
Subtract increase in current assets	(1)	(30)	(17)	(8)		(7)	(7)
Add back increase in current liabilities	21	29	26	13		10	11
Subtract mCAPEX (m*increase in fixed assets at cost)	**(24)**	**(24)**	**(147)**	**(108)**		**(103)**	**(111)**
Add back after-tax interest on debt	13	13	11	18		18	18
Free cash flow	127	111	18	70		88	94
PV CF	120	99	14	53		61	60

Fair Valuation Calculation

Sum PVCF	1,685
PVTermV	267
BkLiabilities	384
Cash/STinv (After Tax)	44
Value of the Firm	1,612
Number of Shares	18.0
Stock Price	89.63
Margin of Safety	1.37%

Beta Calculation

REGRESSION SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.539938121
R Square	0.291533175
Adjusted R Square	0.288094016
Standard Error	0.02885855
Observations	208

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	0.070596749	0.070596749	84.76873143	3.89144E-17
Residual	206	0.17156008	0.000832816		
Total	207	0.242156829			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Alpha	0.003038385	0.002016558	1.506718579	0.133414733	-0.000937353	0.007014123
Beta	0.850093267	0.092331254	9.206993615	3.89144E-17	0.668057891	1.032128644

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