



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

CHDN - NASDAQ (as of 3/1/17)	\$152.30
Price Target	N/A
52-Week Range	\$118.76 - \$157.15
Shares Outstanding (mm) (basic)	16.4
Market Cap. (\$mm)	\$2,498
3-Mo. Average Daily Volume	90,630
Institutional Ownership	72%
Total Debt/Total Capital (12/16) *	57%
ROE (TTM ended 12/16)	17%
Book Value/Share (12/16)	\$42.40
Price/Book Value	3.6x
Annual Dividend & Yield	\$1.32 0.9%
EBITDA Margin (TTM ended 12/16)	26%

* excludes earn-out and deferred payment liabilities associated with 2015 acquisition

EPS FY 12/31 (GAAP-based, from contin. operations)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	(\$0.09)	\$0.16		
2Q	\$3.10	\$4.11		
3Q	\$0.24	\$0.52		
4Q	\$0.43	\$1.60		
Year	\$3.71	\$6.42	\$6.30	\$6.70
P/E	41.1x	23.7x		22.7x

Note: Quarterly EPS figures may not add to annual figure due to rounding.

Revenue (\$mm)

	2015	2016	Prior 2017E	Curr. 2017E
1Q	\$251	\$288		
2Q	\$409	\$439		
3Q	\$280	\$303		
4Q	\$272	\$278		
Year	\$1,212	\$1,309	\$1,390	\$1,330

Company Description: Churchill Downs Incorporated, headquartered in Louisville, KY, is a racing, gaming, and online entertainment company. It owns and operates thoroughbred racetracks including its namesake facility, which hosts the annual Kentucky Derby. The company's other businesses include land-based casino gaming, the TwinSpires online account wagering platform, and mobile videogame developing/publishing.

Churchill Downs Incorporated

CHDN — NASDAQ — Neutral-3

4Q Pros and Cons; Maintain Neutral Rating Due to Valuation

Investment Highlights

- **Fourth quarter results were mixed, in our view.** Total revenues of \$278.3 million were a bit shy of our estimate of \$290.0 million. Similarly, adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) of \$56.5 million were a few million dollars below our projection. We underestimated some challenging operating conditions with the regional casino business, such as competition and local economies.
- **Elsewhere, we felt CHDN's portfolio of businesses delivered generally encouraging performances.** We liked gains in market share, revenues, and profits at the TwinSpires online wagering platform. In addition, we liked sequential and year-over-year improvements at the Big Fish Games mobile videogame segment, which we sense disappointed some investors in recent quarters. 4Q represents a seasonally slow quarter for the live racing segment.
- **We have updated our 2017 financial outlook.** We have lowered our revenue estimate by \$60 million mainly due to a more conservative assumption at Big Fish Games, while our adjusted EBITDA estimate is lowered only slightly, as we have raised our overall adjusted EBITDA margin assumption.
- **In December 2016, we lowered our rating on CHDN to Neutral from Buy.** Price appreciation had pushed the stock valuation above our preferred level for purchases. We maintain our overall favorable view of the company and its business prospects. We expect growth in CHDN's revenues and cash flows in each of the next several years. We could consider a return to a purchase recommendation at a lower stock price, assuming no change in company fundamentals. Our Suitability rating on CHDN is 3.

**Note Important Disclosures on Pages 6-7.
Note Analyst Certification on Page 6.**

Exhibit 1**Consolidated Statements of Income** (figures in millions except per share data and percentages)

	Quarter Ended			Year Ended		
	<u>12/31/16</u>	<u>12/31/15</u>	<u>% chg.</u>	<u>12/31/16</u>	<u>12/31/15</u>	<u>% chg.</u>
Net Revenues	\$278.3	\$272.4	2.2%	\$1,308.6	\$1,212.3	7.9%
Operating Expenses	225.1	223.4	0.8%	993.0	922.9	7.6%
Gross Profit	53.2	49.0	8.6%	315.6	289.4	9.1%
Selling, Gen. and Admin. Exp.	24.9	22.5	10.7%	100.2	90.8	10.4%
Calder Exit Costs	0.1	0.4		2.5	13.9	
Research and Development	9.7	9.4		39.0	39.4	
Gain on Calder Land Sale	(23.7)	0.0		(23.7)	0.0	
Acquisition Related Charges	(1.5)	4.3		3.4	21.7	
Operating Income	43.7	12.4	252.4%	194.2	123.6	57.1%
Interest Expense, net	(10.9)	(7.5)	45.3%	(43.7)	(28.6)	52.8%
Equity in Gains of Unconsol. Invest.	3.9	3.0	30.0%	17.4	11.2	55.4%
Misc., net	0.5	0.4		0.2	5.9	
Total Other Income	(6.5)	(4.1)	58.5%	(26.1)	(11.5)	127.0%
Income Before Taxes	37.2	8.3	348.2%	168.1	112.1	50.0%
Taxes	10.4	0.8	NMF	60.0	46.9	27.9%
Net Income	\$26.8	\$7.5	257.3%	\$108.1	\$65.2	65.8%
Diluted Earnings Per Share	\$1.60	\$0.43	268.0%	\$6.42	\$3.71	73.0%
Segment Adjusted EBITDA (Earnings Before Int., Taxes, Deprec. & Amort.)	\$56.5	\$53.6	5.4%	\$334.5	\$302.5	10.6%
Avg. Diluted Shares Outst.	16.8	17.3	(2.9%)	16.8	17.6	(4.5%)
% of Net Revenues:			bp chg.			bp chg.
Gross Profit	19.12%	17.99%	113	24.12%	23.87%	25
Selling, Gen. and Admin. Exp.	8.95%	8.26%	69	7.66%	7.49%	17
Adjusted EBITDA	20.30%	19.68%	62	25.56%	24.95%	61
Operating Income	15.70%	4.55%	1,115	14.84%	10.20%	464
Net Income	9.63%	2.75%	688	8.26%	5.38%	288
Tax Rate	27.96%	9.64%	1,832	35.69%	41.84%	(614)

Source: Churchill Downs Incorporated

Additional comments on 4Q. In the Casino segment, issues such as competition and regional economies represented challenges, as segment revenues declined 1.9% and adjusted EBITDA dropped 1.8%. Business at the Oxford, Maine property continued to be solid, supporting plans for an adjacent hotel in mid-2017.

The TwinSpires (online wagering) segment performed well once again as it continued to add customers and capture market share. This segment produced a 10.4% revenue gain and an 11.8% rise in adjusted EBITDA.

The Racing segment had a mostly uneventful quarter, as this represented a seasonal slow time for the business. Segment revenues and profits were similar to a year ago.

Big Fish Games generated a 2.5% increase in 4Q revenues and a substantial 33.2% gain in adjusted EBITDA. This was a bit of a positive surprise to us, with results boosted by lower levels of user acquisition spending compared to recent quarters. Segment EBITDA margin surged about 500 basis points.

The company's GAAP-based EPS for 4Q were \$1.60, well above the year ago figure of \$0.43 and boosted by a gain on the sale of some excess land at Calder Race Course in Florida. However, we do not feel GAAP-based earnings is a major focal point among investors. The weighted average share count in 4Q was 2.9% lower due to past repurchases made under the company's repurchase authorization. About \$121 million remains on the authorization.

Financial condition. We consider CHDN's financial condition solid. At the end of 4Q 2016, total interest-bearing debt was \$921.7 million (not including earn-out and deferred payment liabilities totaling \$95.7 million related to Big Fish Games). This represented about 57% of total capitalization. The period-end leverage ratio (total debt excluding Big Fish deferred liabilities divided by trailing adjusted EBITDA) was 2.6x, a manageable figure that leaves room for future borrowing if needed, in our view. Also, we believe strong cash flows from CHDN's mix of businesses can allow for deleveraging in the coming years. We also expect annual increases in the dividend (we note a 15% rate increase effective with the January 2017 payment) and continued share buybacks.

Outlook. We continue to view CHDN's business prospects favorably. For 2017, we expect successful meets at the Churchill Downs track in Louisville, KY, including a potential record haul from Kentucky Derby week based on some capacity additions, some pricing benefit, and generally high levels of popularity for the week's events. We also expect continued outperformance from the TwinSpires online wagering platform versus the thoroughbred wagering industry and stable contribution from the wholly owned casinos. Equity in a variety of casino/hotel joint ventures adds to our bullish view. We have assumed adjusted EBITDA growth at Big Fish Games due mainly to less aggressive user acquisition spending.

For 2017, we project revenue of \$1.330 billion, adjusted EBITDA of \$365 million, and GAAP-based EPS of \$6.70. Although we like the potential for a good year, we are mindful of issues such as start-up expenses for new businesses, competitive environments, regional economies, legislative factors, and total debt levels. We have not assumed future contributions from online casino-style gaming, a business the company continues to pursue yet is dependent on legislative approvals. Similarly, we have not assumed future passage of legislation that could allow gaming operations at the company's Kentucky and Illinois racetracks.

Stock price and valuation. CHDN shares are currently trading at 22.7x our 2017 EPS estimate; however, we feel an Enterprise Value/EBITDA (earnings before interest, taxes, depreciation and amortization) valuation approach is most relevant due to CHDN's debt levels and non-cash expenses such as depreciation & amortization. This measure focuses on the implied total value of a company (market capitalization plus net debt) relative to its cash flow generating ability and is commonly used in the analysis of many companies in the Entertainment & Leisure spectrum, including CHDN.

As noted in Exhibit 2, Enterprise Value (using estimated year-end net debt figures) divided by 2016 adjusted EBITDA is 10.5x, while the valuation on our projection of 2017 adjusted EBITDA and year-end net debt is 9.3x. This is a similar valuation at the time of our rating downgrade to Neutral on 12/9/16. Furthermore, roughly one year ago, the EV/adjusted EBITDA valuation was 8.6x based on our 2016 adjusted EBITDA estimate. We estimate a historical range of 8x-11x over the past five years. We feel a multiple in the 8-10x range can be justified by company fundamentals, recent and future growth initiatives, and the cash flow outlook.

In what we view as a conservative measure, for the purpose of an EV/EBITDA valuation analysis we have added certain short-term and long-term liabilities related to Big Fish Games (deferred payments and earn-out liabilities) to the traditional debt categories of term debt and notes, as we view these as future (non-interest bearing) obligations of CHDN. Subtracting period end cash, we arrive at net debt.

Exhibit 2**Valuation Analysis** (figures in millions except ratios, percentages, and per share data)

	<u>2017E</u>	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Share Price (3/1/17)	\$152.30				
Recent Diluted Share Count	16.8				
Market Capitalization	\$2,559				
Net Debt, year end ~	\$850	\$969	\$1,107	\$1,104	\$324
Enterprise Value (EV)	\$3,409	\$3,527	\$3,666		
Adj. EBITDA	\$365	\$335	\$303	\$202	\$176
year-over-year % growth	9.1%	10.6%	49.4%	14.9%	11.4%
EV / Adj. EBITDA	9.3x	10.5x	12.1x		

Note: Valuation multiples are based on current market capitalization figures and projected year-end net debt levels.

~ Net debt figures include short-term and long-term notes and term loan balances, plus short-term and long-term earn-out liabilities and deferred payments owed to Big Fish Games, minus cash & cash equivalents.

Source: Churchill Downs Incorporated and Hilliard Lyons estimates

Opinion. We rate CHDN Neutral on the basis of valuation. We expect higher revenues, cash flow, and profits each year, yet recognize challenges such as a mature live racing industry and competitive environments with the regional casino and mobile videogaming businesses. We are also mindful of sequential profit volatility at Big Fish Games related to factors such as user acquisition spending and platform fees, and game popularity.

On the positive side, we consider the Kentucky Derby event to be one of the most valuable sports/entertainment assets in existence, and believe there are opportunities for continued growth in revenues and profits from the week of related business activity. In addition, we like the company's diversification and expansion efforts over the years, and believe free cash flow can continue to allow for debt reduction, dividend service, and pursuit of growth initiatives. If the stock price and valuation were to decline, we would consider an upgrade to our Neutral rating, assuming no change in company fundamentals.

Suitability. Our Suitability rating on CHDN is 3 on a 1-to-4 scale (1=most conservative, 4=most aggressive), and is based on factors such as industry and company risks, market capitalization, and seasonality to the company's operations.

Risks. In addition to legalities and contractual issues pertaining to alternative gaming, simulcasting, and advance deposit wagering, other factors that could affect the company's financial results and/or its stock price include: general economic conditions, technological advancements, new business ventures, the cost and integration of acquisitions, weather anomalies, insurance costs, the impact of gaming competition, legislative expenses, allocation of live racing days, overall popularity of thoroughbred racing, and competition for top horses and trainers.

Exhibit 3**Business Segment Outlook** (figures in millions except percentages)

	<u>2017E</u>	<u>% chg</u>	<u>2016</u>	<u>% chg</u>	<u>2015</u>
Net Revenues:					
Churchill Downs Racetrack	\$162.0	4.4%	\$155.2	2.7%	\$151.1
Calder Race Course	2.8	7.7%	2.6	(3.7%)	2.7
Arlington Park	56.5	2.2%	55.3	1.7%	54.4
Fair Grounds	39.5	3.9%	38.0	(4.5%)	39.8
Total Racing Operations	260.8	3.9%	251.1	1.2%	248.0
TwinSpires	234.0	6.1%	220.6	10.2%	200.2
Casinos - excluding JVs	340.0	2.2%	332.8	(0.0%)	332.9
Big Fish Games	476.0	(2.1%)	486.2	17.5%	413.7
Other & Corporate	19.2	7.3%	17.9	2.0%	17.5
Net Revenues from Contin. Oper.	\$1,330.0	1.6%	\$1,308.6	7.9%	\$1,212.3
Adjusted Segment EBITDA:					
Racing Operations	84.8	6.4%	79.7	10.9%	71.8
TwinSpires	60.0	8.7%	55.2	13.6%	48.6
Casinos - excluding JVs	106.2	3.3%	102.8	0.6%	102.2
Casinos - equity inv. in JVs, estim.	27.0	17.4%	23.0	81.1%	12.7
Big Fish Games	92.0	16.3%	79.1	15.5%	68.5
Other & Corporate	(5.0)	(5.7%)	(5.3)	307.7%	(1.3)
Adjusted Segment EBITDA ~	\$365.0	9.1%	\$334.5	10.6%	\$302.5
Adjusted EBITDA Margins					
		<u>bp chg.</u>		<u>bp chg.</u>	
Racing Operations	32.52%	77	31.74%	277	28.97%
TwinSpires	25.64%	62	25.02%	74	24.28%
Casinos - excluding JVs	31.24%	35	30.89%	19	30.70%
Casinos - including equity inv. In JVs	39.18%	138	37.80%	329	34.51%
Big Fish Games	19.33%	306	16.27%	(29)	16.56%
Total	27.44%	188	25.56%	61	24.96%

~ Adjusted EBITDA figures exclude nonrecurring items such as insurance losses/recoveries and racing industry trust fund proceeds, and also exclude items such as share-based compensation expense and pre-opening costs.

Source: Churchill Downs Incorporated and Hilliard Lyons estimates

Note: Figures reflect continuing operations only

Additional information is available upon request.

Analyst Certification

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Important Disclosures

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

Investment Ratings

Buy - We believe the stock has significant total return potential in the coming 12 months.

Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

Neutral - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

Underperform - We believe the stock is vulnerable to a price set back in the next 12 months.

Suitability Ratings

1 - A large cap, core holding with a solid history

2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

3 - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

4 - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

<u>Rating</u>	<u>Hilliard Lyons Recommended Issues</u>		<u>Investment Banking Provided in Past 12 Mo.</u>	
	<u># of Stocks Covered</u>	<u>% of Stocks Covered</u>	<u>Banking</u>	<u>No Banking</u>
Buy	36	30%	17%	83%
Hold/Neutral	76	62%	7%	93%
Sell	10	8%	0%	100%

As of 6 February 2017



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

Other Disclosures

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