

## Churchill Downs (30/06/2011)

The fund has a 13.8% position in two US regional gaming and wagering businesses, the largest of which is an almost 10% investment in Churchill Downs Incorporated (CDI).

The core assets of CDI are:

- Freehold ownership of four horse racing tracks. Two of the tracks have sizeable regional casinos on their premises which are owned and operated by the company;
- Leading online (Advanced Deposit Wagering) wagering operations; and
- Standalone casino located in Mississippi.

The way we think about the physical footprint of the business is as follows:

Racetrack assets	Location	Trend in Tote pool	Trend in ADW pool	Casino gaming assets
Churchill Downs	Kentucky	GDP	up	n/a
Arlington Park	Illinois	down	up	n/a
Calder	Florida	down	up	1,200 slots
Fair Grounds	Louisiana	down	up	600 slots
Casino asset (stand alone)				
Harlows	Mississippi	n/a	n/a	900 slots

We consider that the business owns and operates the premiere US racing content in the Kentucky Derby. The performance around this event is similar to the Australian Spring Carnival, where the week of racing and associated events are consistently drawing record crowds and turnover.

Tote wagering turnover in America appears to be in decline - a trend that has been amplified in the current economic environment. Higher quality racing is holding its interest and growing, but the industry as a whole seems to be suffering from overcapacity. There has also been steady substitution of turnover from the tote to online sources (ADW). The company owns and operates the largest online businesses in America and this migration towards online turnover is accretive compared to the margins they earn in their traditional tote business. The environment for US racing is clearly difficult, but we feel Churchill Downs is well positioned given its skew towards higher quality racing and its strong positioning on the ADW / online business.

The two casinos that Churchill Downs own and operate at their tracks in Florida and Louisiana are the result of initiatives from the individual States to support the racing industry. The rationale for the licences is that a portion of the revenues from the slots are distributed to the racing industry

stakeholders. The casino licences are valuable to the racetrack as they generate profits from their operation and improve the racing offering through higher prize money driving increased tote and ADW turnover. Ultimately, we think it is likely Churchill Downs will over time gain casino licences in both Illinois and Kentucky.

Over the past three years management have reinvested the free cashflow into two significant acquisitions:

- building out their position in the online space; and
- acquiring a regional casino in September 2010 for \$138m.

We hold management in high regard. They appear to have a strong operational focus, they are not wedded to racing ahead of shareholder returns and they have a strong understanding of return on investment / capital allocation decisions.

The current enterprise value of the business is US\$950m and the balance sheet is modestly geared (ignoring the specifics of the investment arithmetic, US\$950m strikes us as low in the context of the physical assets, businesses and content they own). After normalising the earnings base for the acquisitions, we expect CDI to generate about \$105m in free cashflow (pre interest and tax but after capex) this year. Overtime we expect this coupon will grow organically at mid single digits driven by the quality of their racing content, specifically the Kentucky Derby, and the margin accretion the business realises from the substitution of turnover from the traditional tote to online sources. Given our view of the asset quality, modestly geared balance sheet and high regard for management, we are prepared to capitalise this coupon at 8.5%, suggesting a value for the company of \$62 / share, compared to its current price of \$43. Moreover, we regard our valuation as reasonably conservative – there is nothing attributed to the likelihood of additional casino licences in Illinois and Kentucky, improved performance from the racing business or a broader improvement in the economic environment. We think the market isn't realising this value because the cash generating power of the business has been obscured by the recent acquisitions and the market generally holding the view that racing is in decline. Our view is despite the overall decline, there are some desirable parts of the wagering business to invest in and we think we are getting confirmation of this view from the recent financial results of the company.

Following is a long term chart of CDI's share price. The fund acquired the bulk of its investment from May to July 2010.

Churchill Downs Inc. (NasdaqGS:CHDN) - Share Pricing **Open:** 18.00 **High:** 57.41 **Low:** 15.75 **Close:** 42.95 **Avg:** 31.45



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