WILSONS

The Business of Gaming

Our weekly view on Australian equities.

21 October 2021

A Period of Profound Structural Change

The gaming industry, which has traditionally delivered GDP-like growth rates across many decades, is now facing a period of profound structural change. The confluence of technology, regulation and product innovation are all playing a part in determining how capital is being allocated.

New areas of gaming, particularly in digital, are growing at 4-5x GDP and look to have the ability to sustain high growth rates to the end of the decade.

Australians have over-indexed on gaming consumption since the First Fleet. A public holiday for a horse race, a game of two-up on our national holiday all suggest a deep cultural knowledge base. The industry has developed an experienced skill set of operators and investors who know and understand the sector, with skills being exported across the world.

Global facing **Aristocrat Leisure (ALL)** this week undertook a $A5bn acquisition of UK-based digital gaming platform Playtech (PTEC.L) - its largest to date - further shaping the company's future along digital lines. ALL is a member of the Wilsons Australian Equity Focus List.

Tabcorp (TAH) is in the middle of splitting itself into two via a demerger, reversing what was put together less than five years ago. TAH is the likely front-runner in the pending sale/ privatisation of WA TAB from the Western Australian government, which press reports are suggesting could be worth up to A$1bn.

US-based **Scientific Gaming (SGMS. NASDAQ)** have publicly announced the IPO of its global lotteries business on the ASX by the end of the year, with press reports suggesting the company has a market cap of ~$A8bn.

We unpack the drivers behind these companies reorganising themselves and identify where we believe opportunities are currently mispriced.

The Gaming Sub-Sectors

Gaming exposed companies in the consumer discretionary sector are split across five sub-sectors reflective of industry position. Common across all industry verticals are:

- Defensive revenue streams
- Significant levels of government regulations
- The emergence of the digital gaming experience

Legacy operators have harnessed the benefit for scale (regulators prefer few rather than many), with most businesses in Australia operating within oligopolistic industry structures.

This allows most companies to generate respectable returns on capital.

Emerging operators like BetMakers (BET), Jumbo Interactive (JIN) and Pointsbet (PBH) are trying to disrupt but have yet to reach a level of scale. Given the specific industry challenges with casinos operators at present, we have not focused on them in this report.

Exhibit 1: Australian gaming landscape and key players

Sectors	ASX Listed Operators	Key Products	Growth Outlook	Global TAM (USDbn)
Gaming Machines	ALL, AGI	Electronic gaming machines	Mature	150
Lotteries	JIN, TAH	Jackpots, scratch cards	Growth	300
Casinos	CWN, SGR, SKC	Land based destination properties	Mature	125
Digital Gaming	ALL, PBH	Mobile, social gaming	High Growth	65
Wagering	BET, TAH	Sports betting	Growth	95

Source: TAM is 2021, La Fleurs World Lottery Almanac 2021, Reportlinker.com

Industry Growth Rates

While the lottery sector is mature, it still manages to increase revenues in line with GDP growth. Global spending on lotteries has increased at a compound annual growth rate (CAGR) of 3.6% between 2005-2020. (La Fleurs World Lottery Almanac 2021). Into 2025, this should increase to 4.1% (2020-2025E) to ~$US400bn, primarily driven by the digitisation of the consumer experience and offset by slower but still positive growth in traditional card/scratch lotteries.

Digital lotteries, or iLotteries as the category is known, is anticipated to outpace industry growth by 3-4x into 2025. The drivers are very similar to other industries where digitalisation is being embraced.

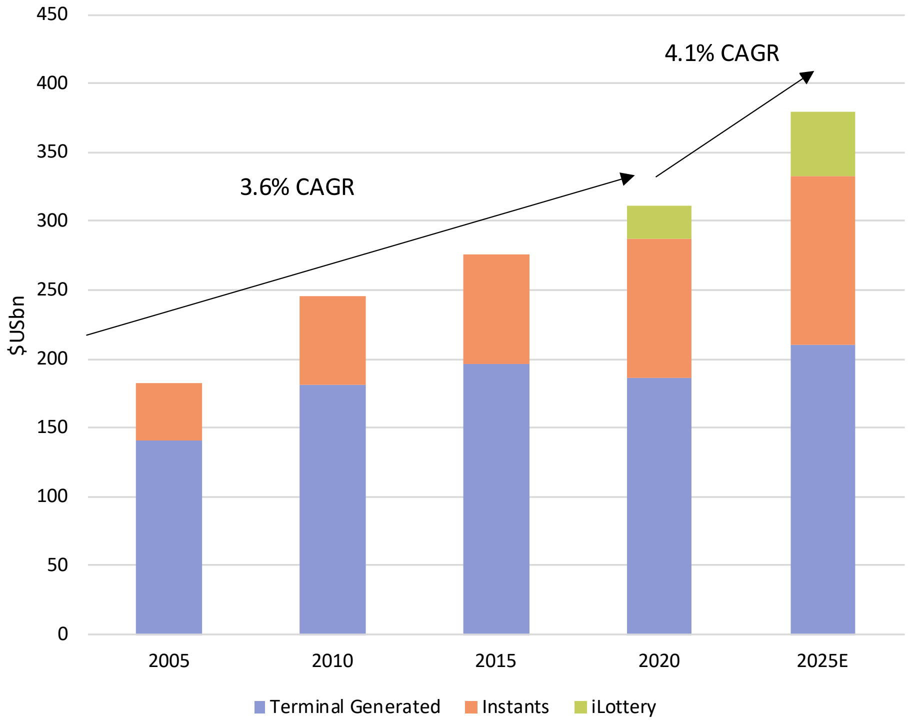
Digital gaming:

1. Expands the addressable market
2. Removes friction costs for consumers
3. Allows for greater product innovation

Governments tend to support the transition given digital provides the ability for greater controls/oversight, while category growth provides an increased pool of takings.

TAH's lotteries business is expected to grow at ~7% CAGR 2017-2024E (according to Refinitiv), well ahead of underlying Australian GDP growth.

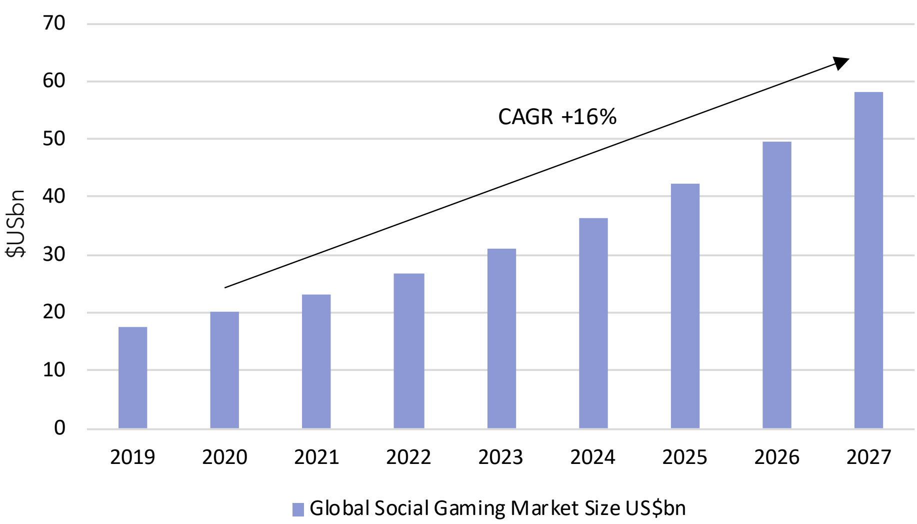
Exhibit 2: Industry growth rates of lotteries has been GDP-like over an extended period



Source: La Fleur's World Lottery Almanac

Product innovation is behind the higher growth - larger prize pools or jackpots are the prime driver. TAB is looking to change the gameplay in the key Oz Lotto business in 2022. The last time game changes occurred in 2018 growth spiked to +20% and +30% on the previous corresponding period (pcp) in the following two halves.

Exhibit 3: Social gaming is expected to grow +16% CAGR into 2027



Source: Coherent Market Insights

The Digital Acceleration

The gaming industry has lagged much of the broader economy in the move to digital. A mixture of government regulation, oligopoly industry structures and large installed capital bases that companies have looked to protect have combined to hold back industry innovation.

We are now seeing the industry aggressively pivot to digital. The consumer desire to remove friction (online and mobile), increase innovation (new games), and introduce new areas of gaming (sports, social casino, social gaming) suggests a long pathway of growth ahead. Regulatory changes, particularly in the US – the largest gaming market in the world - are also expected to act as a tailwind. The net effect is the total addressable market (TAM) of gaming globally increasing, given changes that allow both greater reach and depth.

Investor capital is already moving in response, pushing up valuation multiples of companies that have pivoted to digital. Gaming businesses like NeoGames (NGMS.NASDAQ) and Flutter (FLTRF.L) are both overweight digital and command multiples of +20x EV/EBITDA, with +20% EPS 3-year EPS CAGR.

We believe investors will follow the growth, pushing up valuation multiples of gaming companies that pivot to digital.

Key Areas of Digital Gaming

The digital gaming category is blurring the lines between traditional real money games and entertainment. Whilst categories like iGaming and sports betting replicate offline experiences in a digital environment with real money at stake, Social casino allows players to earn credits in exchange for (real) money. While social gaming is conducted via online social networks/platforms purely for entertainment.

Key gaming operators are increasing focus across all parts of digital verticals, blurring the lines of traditional gaming-focused companies and tech-like entertainment companies. The creation of game content can be monetised in numerous ways. The nature of revenue is more subscription-like vs turnover-based revenue, which only adds to investor appeal behind the gaming pivot to digital.

Exhibit 4: Key areas of digital gaming

Sectors	Feature	Key Products	Key Platform	Global TAM (USDbn)
iGaming	Real Money	Slots, Tables, Poker, Bingo	Mobile	40
Sports betting/Live Casino	Real Money	Bet 365, IGT, Flutter	Online/Mobile	66
Social Casino	Credits, exchanged for money	Doubledown Casino, Slotomania, Zynga Poker, Big Fish Casino	Online/Mobile	9
Social Gaming	Entertainment/ non-monetary	Gaming via social platforms	Mobile	124

Source: H2 Gaming Capital and Wall Street research, Grandview, Newzoo. TAM is estimated 2025.

Our View on Aristocrat (ALL)

Aristocrat (ALL) is a member of the Focus List, weighting 3.5%

The all-cash $A5bn purchase of Playtech in the UK expands ALL's push into digital gaming. Playtech is exposed to the online real money gaming (RMG) category – which currently has a TAM +$US70bn (think online casino, poker, bingo etc.).

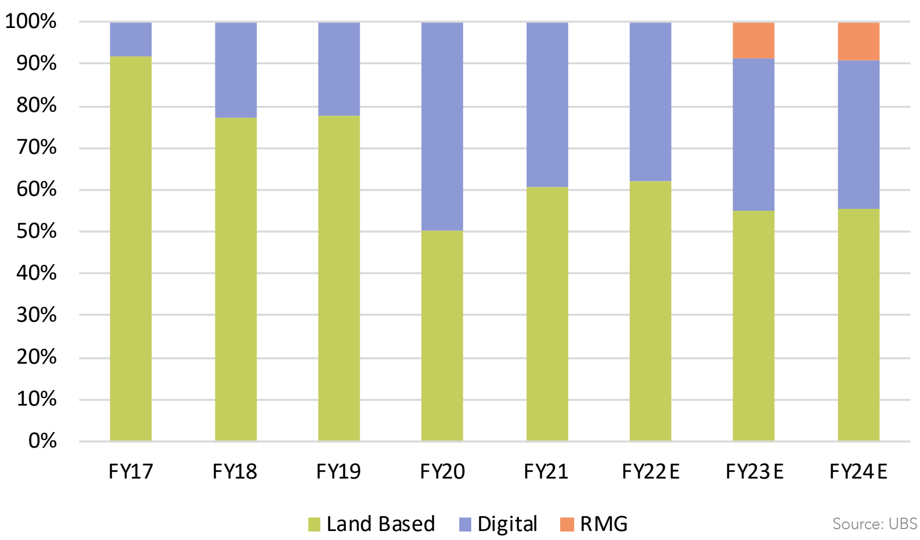
The category is fast-growing, led by the rise of online gaming – which is being pushed along by the deregulation of gambling across US states. Market forecasts have the US RMG category growing from $US4bn to $US20bn by 2025.

The purchase price of 11.4x EV/EBITDA compares to ALL at 17x – making the deal accretive from FY21. The transaction will result in ALL digital businesses being larger than ALL's traditional land-based gaming machine businesses.

We think Playtech will be well received by investors, in contrast to Plarium/Big Fish digital acquisitions in 2017/18, where investors worried about ALL's pivot to digital.

Post-Playtech, the market is looking for mid-teens EPS CAGR into FY25E, which is well ahead of market. Trading on an FY1 27x PER, in line with the Industrials ex-financials, ALL continues to represent good value in our view.

Exhibit 5: ALL is pivoting aggressively to digital, now >50% of revenue



Source: UBS

Our View on Tabcorp (TAH)

TAH is a domestic gaming conglomerate that has struggled to live up to expectations of growth post the TAH and Tattersalls merger in 2017. Today, the group is planning a demerger, effective mid-2022 post shareholder approval.

The demerger will result in a pure-play lotteries business and separate wagering business.

Lotteries continue to experience growth, while wagering is pressured by structural changes, legacy assets and having been heavily impacted by COVID. Put simply, too many old assets, not enough digital in the eyes of investors.

Within wagering (45% of group EBITDA) the market is expecting no revenue growth from between FY18 and FY24E, while costs pressures are likely to take 15% off core earnings over the same period. Understandably the market is frustrated by the poor outlook.

The rejection in 2021 of a $3.5bn takeover for the wagering assets only compounds the issue.

Could TAH be worth more than the current share price of $5.10? Perhaps. The key is what assumption you place on earnings multiple applied to TAH's Lotteries business. Globally, the range is between 10-20x EV/EBITDA. Backing out wagering at $3.5bn equivalent to 8x EV/EBITDA, lotteries trades on an implied 14x multiple for what is a mid-single-digit domestic growth story. Perhaps as a standalone business, lotteries could command a high-teens multiple.

The potential global SG Lotteries IPO on the ASX this quarter presents competition for investor interest. SG Lotteries offers a global growth story, with key exposure to deregulation thematic in the US – exposures TAH does not have. Press reports indicate IPO pricing expectations in the mid-teens EV/EBITDA.

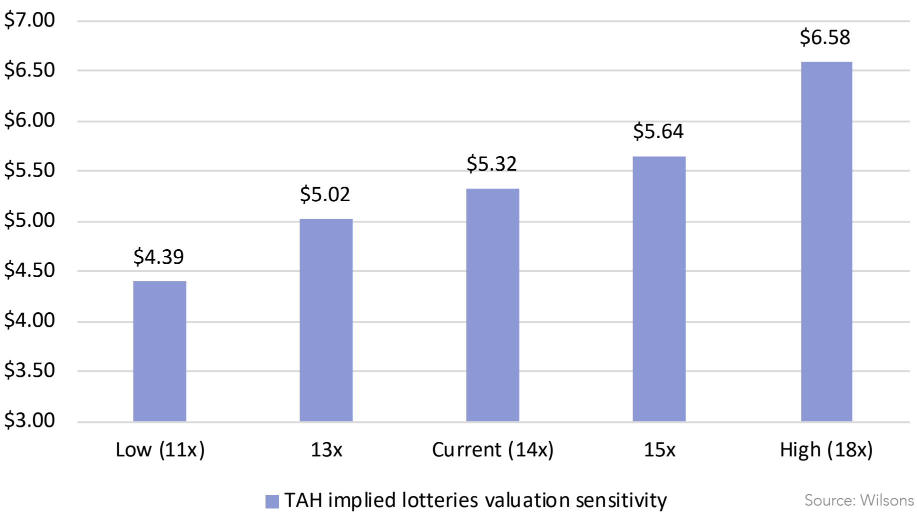
While we are supportive of TAH's demerger strategy, we find it hard to get too bullish about potential multiple uplift for TAH when there is potential for increased competition for investor interest in the lotteries business, and the anchor valuation of wagering at 8x EV/EBITDA is based on takeover interest (inclusive of control premium). With core earnings going backwards into 2025, 8x may still be a too generous multiple.

Exhibit 6: TAH lotteries business is hidden within a conglomerate with implied value 14x EV/EBITDA

	EBITDA FY23E	EBITDA Multiple	Valuation ($Am)	Per Share ($A)	Comment
Lotteries & Keno	686	14.0	9,581	4.38	Implied multiple
Wagering & Gaming	518	7.7	4,000	1.83	$4bn value re Apollo offer 2Q20
Consensus EBITDA FY23	1204	11.3	13,581	6.20	
Net Debt FY23 (consensus)			1,690	0.77	
Demerger Cost			250	0.11	TAH cost guidance
Valuation of TAH			**11,641**	**$5.32**	**Implies ~5% upside to $5.09 share price**

Source: Wilsons

Exhibit 7: TAH valuation sensitivity to different multiples on the lotteries business



Source: Wilsons

News Corporation (NWS) and Telstra (TLS) at the margin (potential further asset base reorganisation) offer more compelling asset valuation plays in our view, with the prospect of improving core earnings growth to support the valuation. Both are members of the Focus List.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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