Tabcorp (TAH) – Backing Defensive Growth

Our weekly view on Australian equities.

27 April 2022

Hidden Value Still a Key Aspect of the Focus List

We discussed last week the relevance of value in portfolios in the current economic environment.

Read Value Still Supported by Macro Tailwinds

One way of looking for value is looking at the underlying assets of the business and identifying discrepancies between the cumulative value of the operating units versus the market value of the stock. We tend to have a proportion of the Focus List attributed to this way of thinking, which we categorise as "hidden value".

Over the last 2 years, the Focus List has benefited from stocks such as Link (LNK), Aventus (AVN), News Corp (NWS) and Telstra (TLS), where we have identified hidden value. We find this subset of the portfolio can provide above-market returns that are less correlated to the rest of the market. These hidden value stocks rely on management action to highlight value to the market, such as an asset sale or a demerger.

One such stock that has caught our eye is Tabcorp (TAH). TAH plans to demerge the lotteries and Keno business (from the wagering business) to form two standalone ASX-listed companies at the end of May/early June 2022. There should be benefits from the demerger such as:

- Allowing each business to adopt a more focused operating profile and capital structure more aligned to its core operations
- 2 executive teams that can focus on each business more effectively
- M&A opportunities

But in particular, the potential for a market rerating, particularly the lotteries and Keno business.

Focus List Changes

We have added Tabcorp (TAH) to the Focus List at a 3% weighting, while trimming our exposure to Telstra (TLS, -1%), Healthco REIT (HCW, -1%) and CSL (CSL, -1%).

This leaves the Focus List neutral on TLS at 2%. TLS has performed well for us over the last 12 months. We still believe that the stock has upside and like its defensive capabilities but feel there is more near-term upside in TAH.

Trimming CSL to 7% still leaves the Focus List overweight the stock (benchmark at 5.5%). We still believe the stock has upside over the next 12 months but are removing some duration from the portfolio.

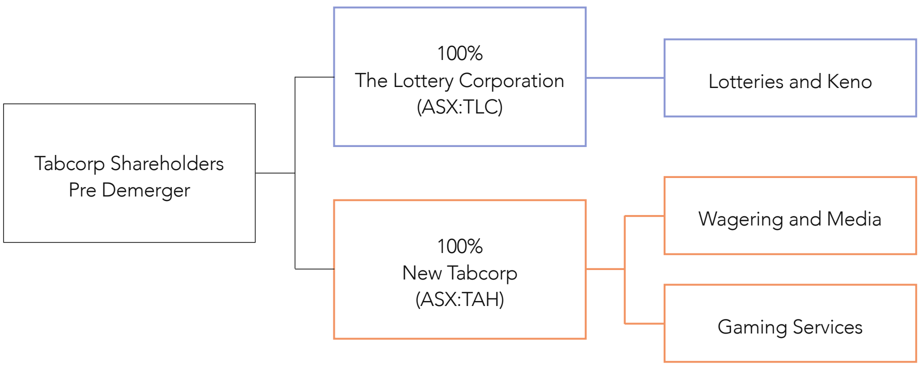
HCW at 2%, leaves the Focus List overweight the stock. We have decreased our weighting to reduce our exposure to a small cap REIT that is sensitive to interest rates. We still like the growth profile and the defensive earnings.

Overview of Tabcorp (TAH) Demerger

Tabcorp's lotteries and Keno business will be demerged into a separate ASX-listed company, The Lottery Corporation (TLC).

Shareholders will vote for the demerger on 12 May 2022. If voted for, shareholders will retain their current existing shares in Tabcorp and receive one TLC share on 25 May 2022. The shares will commence trading on 24 May 2022 on a deferred settlement basis, with trading on a normal settlement basis expected on 2 June 2022.

Figure 1: TAH post demerger structure



Source: Company data, Refinitiv, Wilsons.

Focus on Lotteries

We believe that the lotteries and Keno business is key to a rerate, and should provide upside to today's share price. This is predicated on 3 factors:

1. Lotteries is a defensive, infrastructure like business with long-dated licences.
2. Lotteries is growing its online presence which could lead to margin expansion.
3. Lotteries is highly cash generative and capital light.

Defensive business, higher valuation

Despite arguably being a discretionary purchase, lotteries exhibit annuity-like characteristics, with the key drivers of growth being stable factors such as population growth. Keno tends to be more sensitive to macroeconomic factors; however, this part of the business only accounts for 10% of the lotteries segment.

The TAH lotteries segment has achieved consistent growth in revenue and earnings throughout the economic cycle (including COVID-19). This is mainly driven via base games, which provide a predictable revenue stream from loyal customers. Base games account for 56% of the lotteries business' revenue.

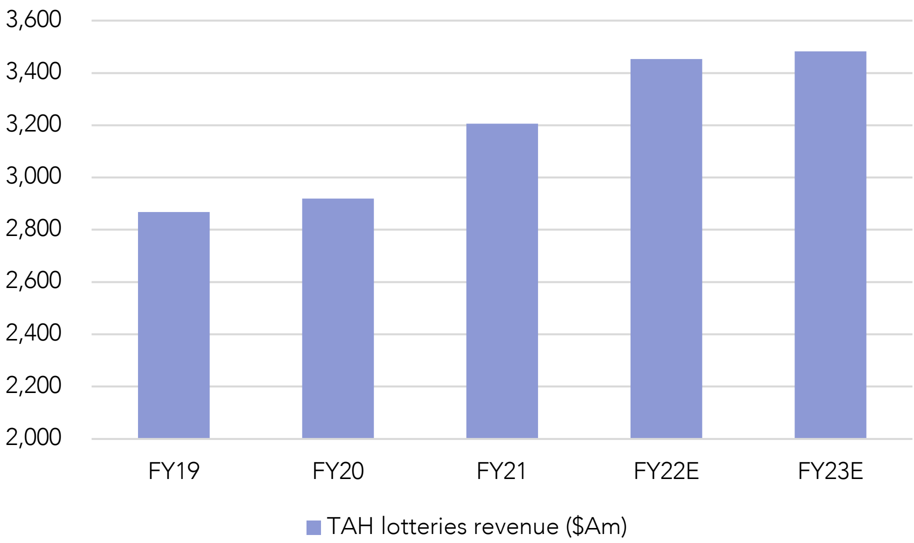
The Lottery Corporation has a significant and broad customer base. In the last 12 months, over 46% of the Australian adult population has purchased a lottery product.

The performance of the lotteries business is underpinned by its long-dated licences. Victoria's lotteries is the next major reapproval. We don't see any reason why this licence would not be reapproved. (Victoria's Keno licence was recently renewed until 2042).

We believe that investors attribute a higher value to defensive companies than those at the mercy of the cycle. Therefore, as a standalone entity we think the lotteries listed entity can rerate from its inherent value today.

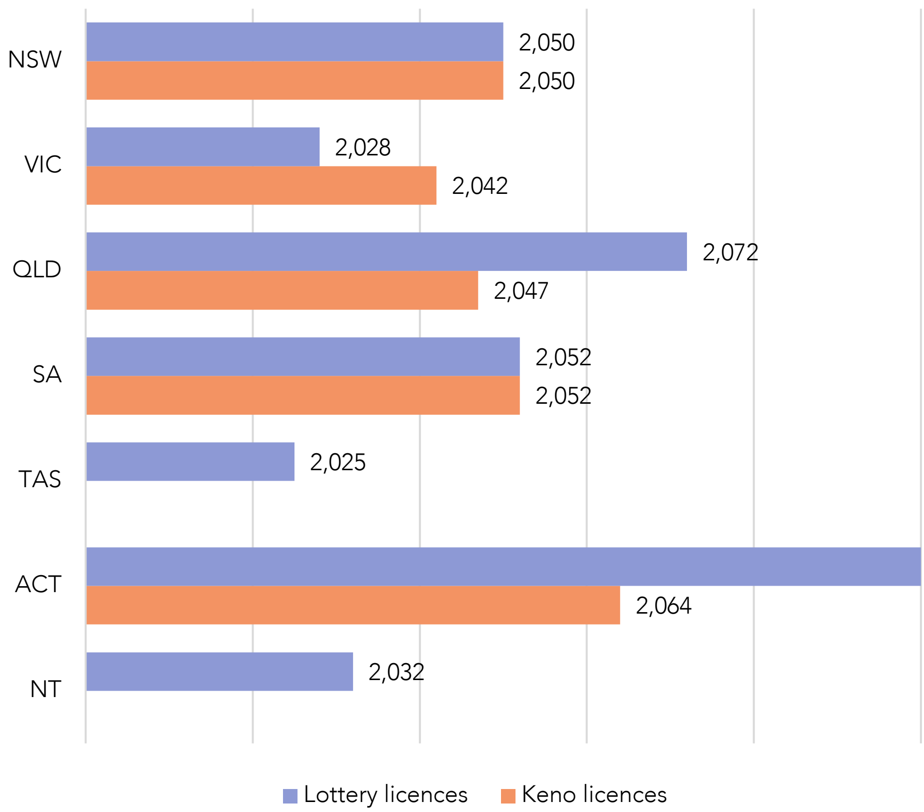
We believe a bid could also be made for the lotteries business after the demerger. Private equity firms typically like annuity-like, defensive companies, just like the lotteries business.

Figure 2: TAH lotteries revenue has remained stable, even during the pandemic



Source: Company data, Refinitiv, Wilsons.

Figure 3: TAH licences are long-dated, reducing the regulatory risk



*ACT lotteries approval is indefinite unless revoked.

Source: Company data, Refinitiv, Wilsons.

Earnings potential with digital expansion

The digital share of turnover is increasing in the lotteries business. Digital sales of lotteries products offer margin upside compared with instore sales. With only ~30% of lotteries sales still online, we believe that there is an opportunity for further digital penetration, which should be earnings accretive via higher margins. Therefore, this segment should still have robust earnings growth over the next few years as this transition continues towards digital sales. We see potential earnings growth for this business in the low double digits over the medium term.

Lotteries is highly cash generative

The lotteries business exhibits strong and resilient free cash flow generation and has low capital intensity.

The lotteries business is capital light. Capital expenditure has decreased over the last 3 years with the completion of the Tatts integration. Capital expenditure is expected to be 5% of EBITDA per annum in the future. This is a lot lower than the wagering and gaming business.

The lotteries business is expected to have a strong operating cash flow conversion ratio of above 100%. High levels of cash generation should mean cash can be reinvested into the business or passed back to shareholders. We believe the market will like this aspect of the lotteries business, providing another factor that could drive a rerate.

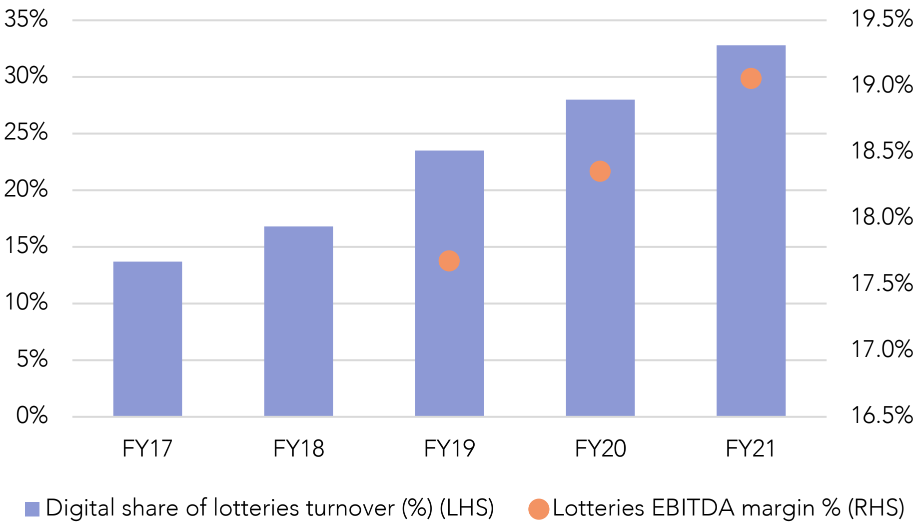
Wagering – Bids Underwrite Value

We think that bids for Tabcorp's wagering, media and gaming services segments undewrite some of the value in the current share price.

Global betting company Entain (ENT.L) and private equity giant Apollo have both bid for TAH's wagering business. Apollo offered $4bn for the wagering, media and gaming services businesses combined.

We believe that this underwrites some of the value in these businesses. Once the business is demerged, further bids may be made for the New Tabcorp (Wagering, Media and Gaming Services).

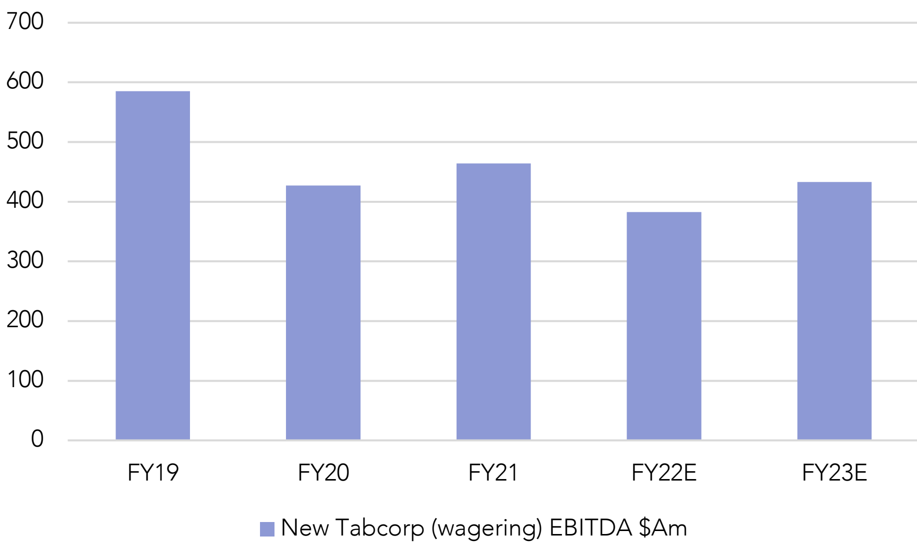
Figure 4: Digital lotteries is margin accretive



*Lottery margin numbers only available since FY19.

Source: Company data, Refinitiv, Wilsons.

Figure 5: COVID-19 impacted Wagering earnings could recover in the next 1-2 years, leading to earnings upgrades



Source: Company data, Refinitiv, Wilsons

It is also worth noting that these bids were during the pandemic when earning within the wagering part of the business had been negatively impacted by COVID mobility restrictions. We are now entering a period where these restrictions are likely in the rear-view mirror and earnings should rebound in FY23.

Value from the Demerger

Can the demerger create upside for investors in TAH? We think it can. Looking at its closest comp, La Francaise des Jeux (FDJ.PA), suggests that the TAH lotteries business could be on a FY23 EBITDA multiple of 16x. FDJ is a French-based lottery operator and is the largest publicly-listed lotteries operator globally.

The FDJ stock currently trades on a multiple of 12.7x forecast FY23 EBITDA but has been severely impacted by company specific events. In July 2021, the European Commission announced that it had commenced an investigation into FDJ to determine whether the decision to grant FDJ exclusive lottery and retail betting rights in France for 25 years violated EU laws.

The share price has fallen on the news while the market has increased over this time period. The stock was trading on a forward multiple of 15.8x before this news hit, and we think this is more appropriate for the lotteries business in Australia with little regulation concern. FDJ also has 20% of its revenue from sports betting, which we think lowers the EBITDA multiple.

Considering the defensive nature of lotteries, earnings growth and the highly cash generative nature of the lotteries business, we think that the multiple could trade higher than 16x. Multiples of this level imply yields of of ~5%, which is comparable to the yields on annuity-type assets (e.g., property) with growth potential.

Figure 5: Sum of the parts valuation exhibits potential upside.

	EBITDA FY23E	Valuation		Implied multiple/Comments	
		Low Estimate	High Estimate	Low Estimate	High Estimate
Lotteries & Keno	721.2	10,818	13,703	15	19
Wagering, Media and Gaming Services	433.3	4,000	4,000	Based on bid from Apollo (9.2x)	
Enterprise Value		**14,818**	**17,703**		
Net Debt		1,901	1,901	Based on FY22E (consensus)	
Demerger Costs		275	275	Inline with management guidance	
Market Value		**12,642**	**15,527**		
Shares on Issue		2,222	2,222	FY21 Shares on issues	
Value per Share		5.7	7.0		
Average		**6.3**		**Implied multiple 17x**	

*At the current price (at writing) of $5.39, we see upside of 17%.

Source: Refinitiv, Wilsons

Disclaimer and Disclosures

Recommendation structure and other definitions

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

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