

Stock Story: Tabcorp

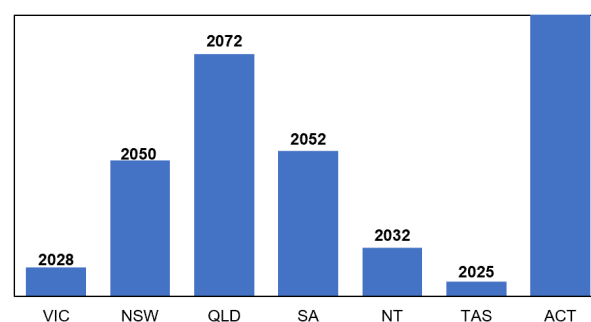
Spinning off the lotteries division is unlocking value.

In the search for high-quality businesses that are undervalued, one of the richest hunting grounds is a 'jewel in the crown' scenario, whereby a great business is hidden within a languishing conglomerate. One of Airle's core holdings, Tabcorp (TAH.ASX), presents such an opportunity, operating a high-quality lottery division whose stellar performance has historically been overshadowed by a structurally challenged wagering division. Fortunately for shareholders, Tabcorp management has made the astute decision to demerge this 'jewel' into a new listed vehicle, The Lotteries Corporation. While this process has already served to unlock material value for shareholders, we believe the market is undervaluing the infrastructure-like qualities of this lotteries division.

THE LOTTERY CORPORATION (LOTTERIES & KENO):

In Australia, lottery licences are awarded exclusively on a state-wide basis. Tabcorp holds all state licences bar Western Australia (operated by the WA government). These state-based monopolies exhibit similar traits to infrastructure concessions; licences are typically long-duration (ranging from 10 to 40 years), demand for the product is insensitive to economic cycles, they feature strong pricing power, and the businesses offer dependable and predictable cash flows. However, lottery concessions are far less capital intensive than their typical infrastructure counterparts. In fact, we estimate that Tabcorp's lotteries division generates a return on invested capital north of 50%!

Lottery Licence Expiries



Source: Company filings, Airle Funds Management.

The crucial factor for a concession operator is whether future licences can be renewed on attractive terms. For lottery concessions specifically, there are some important aspects that heavily favour the incumbent during the bidding process, the most obvious of these being the benefit of economies of scale; Tabcorp is the only private operator of Lottery licences in Australia. This means that any fixed costs related to technology, systems and processes can be shared across the various state licences, resulting in higher profit margins. Given these economies of scale, Tabcorp can operate any individual licence more profitably than a new entrant and thus the company can bid a higher price for that licence.

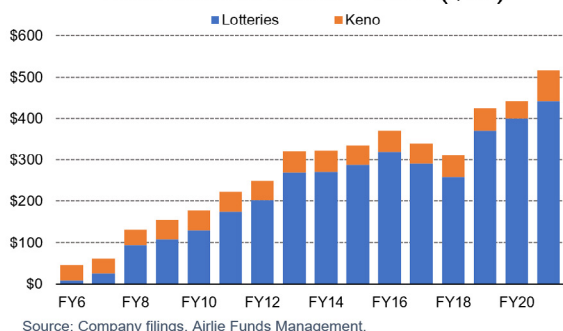
Continuity is also an important consideration during the bidding process. The state government issuing the licence generates material tax revenue based on the value of lottery tickets sold. Any new entrants would need to replicate Tabcorp's existing retail network, customer lists, infrastructure, systems and processes while ensuring no drop in turnover (and tax revenue) for that respective government. These state governments are larger stakeholders in the lottery operations than even Tabcorp; over just the past three years, the lotteries segment has paid over \$5.1 billion in state taxes, dwarfing Tabcorp's estimated profits of less than \$1 billion. It is clearly in the best interest of the various state governments to maximise the turnover performance of the lotteries licences rather than attempt to squeeze extra margin by switching operator.

The only material upcoming licence renewal is the Victorian lottery licence in 2028. Interestingly, while Victoria is one of the highest lottery turnover states, it is also one of the lowest margin licences given the state's higher lottery tax rate. In 2012 when Tabcorp acquired the South Australian Lottery licence, the company disclosed Victoria's 'operator margin' at 3.9%, compared with 9.2%

and 10.5% for NSW and Queensland respectively. Importantly, any new entrant seeking to gain material economies of scale in the market would need to wait until 2050 for the opportunity to bid on the NSW licence. Tabcorp has lost a portion of the Victorian licence before, when Intralot was awarded the instant scratchies portion of the licence in 2007. However, after six years of operation and a reported \$63 million in losses, Intralot forfeited the licence and it was awarded back to Tabcorp.

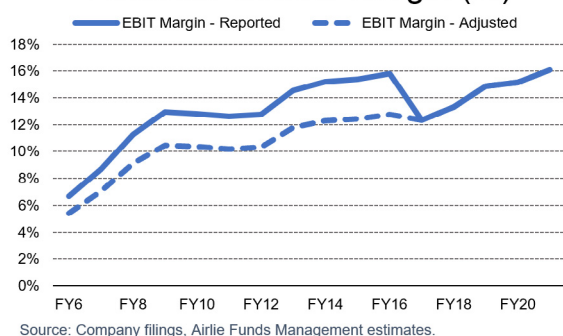
Due to these structural advantages, Tabcorp's lotteries and keno business has one of the most impressive track records of any listed ASX business, growing earnings before interest and tax (EBIT) at a compound annual rate of 9% over the past 10 years.

Lotteries & Keno EBIT (\$m)



As impressive as this track record appears, the earnings momentum here is actually understated; during the Tabcorp/Tatt's merger in 2018, \$65m in costs were reallocated to the Lottery segment, negatively impacting earnings. As can be seen in the chart below, this change in accounting policy had the effect of materially reducing profit margins in FY17 despite having nothing to do with the fundamental performance of the business.

Lotteries & Keno Margin (%)

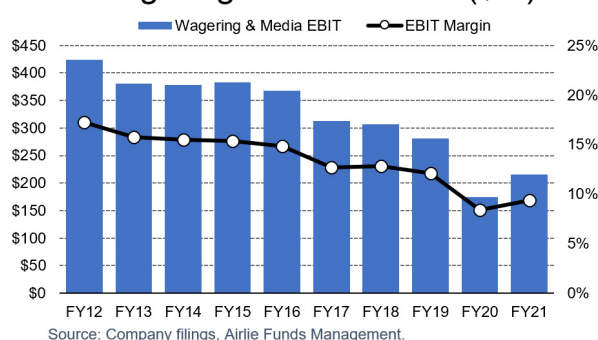


Margin expansion has driven much of the segment's historical growth in earnings, but importantly there are several reasons to believe this can continue; (1) continued economies of scale as the company's fixed costs are spread across a larger revenue base, (2) increasing digital penetration which avoids the ~10.3% commission paid to newsagents, and (3) the superior terms recently negotiated with lottery reseller Jumbo Interactive (JIN.ASX).

THE NEW TABCORP (WAGERING, MEDIA AND GAMING SERVICES):

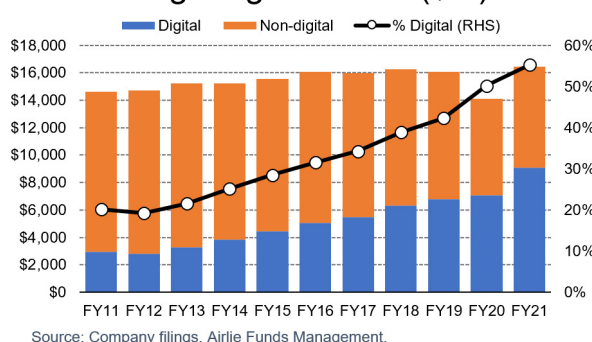
The remaining Tabcorp stub will include the wagering, media and gaming services businesses. The lion's share of value here is in the wagering and media operations. Under the TAB brand, Tabcorp holds the exclusive licence to conduct wagering operations in retail venues across all Australian states and territories excluding Western Australia. This retail monopoly is facing structural disruption as punters increasingly elect to bet with online bookmakers such as SportsBet, Ladbrokes and Bet365. While Tabcorp has its online channels, these digital-first competitors offer superior customer functionality, products and branding, as well as enjoying structural opex and tax advantages. The earnings track record of the wagering and media business reflects these difficulties.

Wagering & Media EBIT (\$m)



But there are glimmers of hope emerging; Tabcorp now generates more than \$9 billion in digital wagering turnover, representing about 55% of total wagering turnover for the group. On a digital-only basis, Tabcorp is the second-largest player in the market, with a 21% share of turnover. Furthermore, recent regulatory changes have helped to level the playing field between Tabcorp and its online competitors by reducing structural tax disadvantages.

Wagering Turnover (\$m)



Clearly other interested parties see value here; Tabcorp has received multiple bids within the last year valuing the wagering and media business at \$3.5 billion (\$4 billion including the gaming services business). While there are significant impediments to completing a transaction (change of ownership provisions and racing body approvals), this does give some indication of the underlying value within the segment not reflected in the current earnings momentum.

VALUATION:

If we ascribe a valuation of \$3 billion to the Tabcorp stub (a material discount to the recent \$4 billion bid from Apollo Global Management), we get an implied earnings multiple for The Lottery Corporation of 19 times fiscal 2022 EBIT. This reflects a 24% premium to the median EV/EBIT of the ASX 300 ex-financials and resources. However, on a normalised cash flow basis – adjusted for return on capital employed – The Lottery Corporation is trading about in line with the market despite its superior growth outlook. As can be seen in the table below, the company compares favourably on a number of metrics with listed toll road concession operators, Transurban and Atlas Arteria. For this reason, despite the strong share price performance, we see material upside in this core holding.

	ROIC	Est. weighted concession expiry	Net debt/EBITDA	Forward EV/EBITDA
The Lottery Corporation	>50%	2050	3.2	16
Transurban (TCL)	<15%	2046	8.4	31
Atlas Arteria (ALX)	<15%	2039	6.1	13

Source: Company filings, FactSet, Airlie Funds Management estimates.

By Will Granger, Airlie Investment Analyst

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