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Davy Research

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Research Report: Sector update

Gaming Conference

Five key observations from Davy's London gaming conference

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Ratings

bwin.Party	Underperform	02/11/10
Ladbrokes	Outperform	14/08/09
Previously	*Underperform*	*30/06/09*
Paddy Power	Outperform	30/06/09
William Hill	Outperform	16/02/11
Previously	*Neutral*	*03/09/10*

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Davy's annual London gaming conference

- Davy's annual London gaming conference took place last Thursday, March 31st.
- In attendance were speakers from bwin.Party, Ladbrokes, Paddy Power, Playtech, Sportingbet and William Hill. Our guest speaker was Patrice Rodrigue, a legal analyst with Gambling Compliance.

Five key sector observations

- Paddy Power remains the best-placed company strategically in the sector.
- A suggested valuation of £300m for Playtech's stake in William Hill Online would imply that William Hill's retail business is too cheap.
- There are too many regulatory uncertainties for us to get comfortable with online gaming stock valuations at present.
- Opposites attract: future consolidation is likely to result in more tie-ups between the regulated and the unregulated.
- It is difficult to see the strategic alliance announcement between Pokerstars and Steve Wynn as anything other than negative for European-listed operators.

Conclusion: our stock views at this point

- We retain 'outperform' ratings on Paddy Power, William Hill and Ladbrokes (although we have a preference for William Hill over Ladbrokes given uncertainties about 888) and retain our 'underperform' rating on bwin.Party.
- We believe there is substantial risk attached to Betfair, particularly given its premium rating. We would also avoid Sportingbet and Unibet at this point.

Five gaming sector observations from our annual London conference

We hosted our annual London gaming conference last Thursday, March 31st. In attendance were speakers from bwin.Party, Ladbrokes, Paddy Power, Playtech, Sportingbet and William Hill. Our guest speaker was Patrice Rodrigue, a legal analyst with Gambling Compliance. The following were our main observations coming away from the day.

1. Paddy Power remains the best-placed company strategically in the sector

The Paddy Power presentation highlighted just how well positioned the group is across each of the markets in which it operates. Indeed, the group continues to win market share in every market in which it competes. In Ireland, its share of the retail market has gone from 25% to north of 30% in the last three years, with competitors continuing to fall by the wayside. In the UK, the roll-out of shops continues with the group on course to achieve a target of 150 shops by year-end. We believe that annual openings will accelerate thereafter (to 40-50 per annum at a minimum) given the economics at play: within three years of opening, shops are generating EBITDA of over £100,000 on an opening cost of £250,000. Those returns may actually continue to improve with greater scale. In online, mobile is exceeding all expectations and the CEO confirmed that the group has torn up its original mobile targets given the success to date. By early March, 31% of online customers had transacted using a mobile device, a number unmatched by any of its listed peers. When asked if mobile was cannibalising other online revenues, the CEO's response was that it was topping them up. In Australia, the main developments within the business have been: (i) an improvement in gross win margins through adoption of better risk management systems, (ii) an ongoing strengthening of the management team and (iii) the early buy-out of the remaining uncontrolled stake which removed any potential short-term/long-term conflicts. The Tabs have a 72% share of the Australian online market versus Paddy Power at 14%. Management remains confident that the overall pie will continue to expand and that its share of that pie will also grow. Critically, the group does not face the same level of future earnings uncertainty as many of its peers given that it markets itself in only regulated markets. As such, it remains a top pick.

2. A suggested valuation of £300m for Playtech's stake in William Hill Online would imply that William Hill's retail business is too cheap

While several questions at the end of the William Hill and Playtech presentations centred on how the current dispute over Playtech's 29% stake in William Hill Online will be resolved (little new could be added given that it is the subject of legal proceedings), we were interested to hear the views of Playtech in terms of what the stake might be worth.

The valuation of the stake will be subject to a process whereby three valuations are made by three separate investment banks: a nominee bank from both Playtech and William Hill and a third independent bank. An average of the three will determine fair value. While that process in theory could still be 18 months away (should the sale not be brought forward), a figure of "at least £300m" was suggested on a number of occasions by Playtech's Head of Investor Relations during the course of the day. While that is just one side's view, it would have implications for the valuation of the entire William Hill group.

Suppose the 29% stake is valued at £300m – this would imply a value for the overall online business of £1,034m. William Hill today has a market cap of £1,243m and forecast net debt as at end-2011 of £459m. Assuming that the stake is acquired by William Hill and that the £300m price tag is funded fully out of debt, this would imply an EV post buy-out of £2.02bn (£1,243m equity + £759m debt). Deducting the £1,034m valuation attached to the online business would leave a valuation for the retail business of £968m. Retail generated EBIT of £204.5m in 2010, implying an historic EV/EBIT for that business of just 4.7x. Based on our 2011 retail EBIT forecast, that multiple would rise to 5.5x (trough earnings). Either way, the retail business looks too cheap. This is just another reason why we think the current valuation of the stock offers considerable upside.

3. There are just too many regulatory uncertainties for us to get comfortable with online gaming stock valuations at present

Regulation, regulation, regulation. The online operators must yearn for the day when they get to talk about their businesses without the cloud of regulation hanging over them. Unfortunately, this is unlikely to be any time soon. The presentations by bwin.Party, Sportingbet and Gambling Compliance touched on regulation in all the major European markets to varying degrees, and we provide a summary of where regulation stands in each market in the appendix of this note.

Our overall conclusion though remains the same: there remain too many uncertainties attached to the online names at this point with the risk still to the downside. To assess whether the current share prices represent good value or not, investors need to be able to come up with answers to the following four questions:

- **Which products will be allowed in which countries and how will they be taxed?**

We are getting closer to getting answers to these questions in the major markets. The next 6-12 months will bring far greater clarity (see our country-by-country summary in the appendix).

- **For those countries that decide to introduce product restrictions (e.g. a ban on casino), what level of earnings (not revenues) will be lost directly as a result?**

Lack of disclosure by operators in terms of the geographical and product composition of their current earnings streams make this impossible to assess at this point. At some point these companies are going to have to spill the beans – in the meantime, they are simply hoping (and actively lobbying) for regulatory decisions that go their way.

- **Post regulation of a market, how long will earnings in that market be depressed by intense competition as operators fight for market share?**

In France, bwin.Party hopes to breakeven in Q4 2011, 15-18 months following the opening up of that market. The question is whether we should expect similar losses (over similar time-frames) to be incurred in each market that regulates. Perhaps France is a particularly gloomy example given the high tax rate on sports? If it is though, and regulation elsewhere is less harsh, will the higher potential returns in these other markets simply lead to more new entrants, with ultimately the same near-term earnings impact?

- **In five years time, when the transition to regulation is complete, what kind of sustainable EBITDA margins (post gaming taxes) will be prevalent in the industry?**

PartyGaming, as a stand-alone entity, has been delivering clean EBITDA margins of 28-30% over the last couple of years. The question is whether the growth in industry gross gaming revenues post regulation will be enough to offset (i) higher taxes and (ii) increased competition from new entrants. Here a whole new set of unknowns come into play: will the US regulate its market (surely it must over five years, at least at state level?); will Pokerstars and Full Tilt still be allowed to dominate the online poker market; what other regions globally will have opened up their markets? The answers to these questions will ultimately influence long-term sustainable returns.

In the short-term, the product/tax decisions of state ministers in Germany will be key for bwin.Party. Developments in Greece and Italy are key for Betfair (at risk of being banned by the former and losing its licence in the latter). Assessing where the earnings of online operators will land in 2012 and 2013 is next to impossible at this point, and anybody claiming that these stocks are cheap based on low 2012 or 2013 earnings multiples is conveniently ignoring the potentially wide deviation of eventual earnings from current forecasts. We retain our 'underperform' recommendation on bwin.Party.

4. Opposites attract: Future consolidation likely to see more tie-ups between the regulated and the unregulated

We think that most of the online-only operators (888, Sportingbet, Unibet) are now looking to merge with, or be acquired by, businesses with a higher proportion of regulated earnings. Frankly, we think that there is an increasing urgency for them to do so.

The online operators recognise that their days of unregulated dot-com operations are numbered. Once regulation comes in, medium-term earnings and cash flow will be constrained, meaning that it will be essential for these businesses to have access to a stable earnings base to adequately compete in newly regulated markets. In their favour, these operators have a number of assets: (i) better technology platforms than traditional land-based gaming providers, (ii) more widely-known online brands and (iii) established customer databases throughout the Continent of Europe. Balanced against these assets, however, is the reality that their unregulated earnings (which make up the vast majority of their earnings) are at risk from (i) bigger competitors, (ii) likely new entrants and (iii) new product restrictions/higher taxes. As such, the onus is increasingly on them to get a deal done and get paid for their assets while they still can.

Ladbrokes and 888: a case of heads, management wins; tails, shareholders lose?

On this point, much of the chatter outside the main conference room was whether a Ladbrokes/888 tie-up is likely to happen and, if so, at what price. Ladbrokes management has to weigh up the need to improve its online product offering on the one hand with the uncertain nature of some of 888's future earnings streams on the other.

While ultimately we have no idea whether a deal will be done, we would suggest that the Ladbrokes management incentive scheme (based on where the Ladbrokes share price gets to over the next four years) makes such a transaction more likely. The way we see it, going the organic route – whereby Ladbrokes gradually improves its sportsbook while negotiating better terms with its suppliers of online gaming products – is less risky. However, it will ultimately only bring the group so far. Acquiring new technologies, new customers and new brands, while far riskier, also offers far greater potential upside should it actually work. As such, we feel the current structure potentially rewards management to take greater levels of risk.

While we have an 'outperform' rating on Ladbrokes based on upside to valuation as things stand, it is fair to say that William Hill offers a lower-risk way of playing the sector at this point given similar upside.

5. It's hard to view the strategic alliance announcement between Pokerstars and Steve Wynn as anything other than negative for European-listed operators

Bwin.Party admitted that it was "initially aghast" when hearing the news that Steve Wynn has signed a strategic partnership agreement with Pokerstars to lobby for US online poker reform and to jointly apply for an online licence in the US should the market ever regulate. Thinking about it though, Wynn has very little to lose. If Pokerstars does not win a licence in the US, he can look to do deals with other technology providers (somebody will forgive him and offer to sell him services!). If Pokerstars is allowed to operate in the US post regulation, he gets to share in what is a very profitable business currently. From a bwin.Party perspective, it was keen to point out that if the Wynn-Pokerstars alliance helps to get legislation passed, this would ultimately be a good thing. For us though, the future value of bwin.Party's US operations would be significantly lower if Pokerstars is permitted to continue to operate in that market in the future. Expect big lawsuits if PokerStars and Full Tilt get US licences down the road.

Conclusion: our stock views at this point

We retain 'outperform' ratings on Paddy Power, William Hill and Ladbrokes (although we have a preference for William Hill over Ladbrokes given uncertainties about 888). We retain our 'underperform' rating on bwin.Party. We believe there is substantial risk attached to Betfair, particularly given its premium rating. We also would avoid Sportingbet and Unibet at this point.

Appendix: country-by-country review of EU online gaming regulation

The following is a summary of where things stand in the major markets:

Germany

Clarity approaches, but it is still unclear how much this week will bring. The state ministers meet on April 6th to try to thrash out more of the details regarding what other products will be permitted (so far there is only a commitment to regulate sports betting), with operators expressing hope that poker will also be allowed. Casino appears to be unlikely at this point. The hope is that a tax based on gross gaming revenues rather than turnover will be introduced, although there is no clarity on what the rates will be at this point. While a decision is possible on April 6th, the more likely outcome is that a decision will come in mid-June.

Exposure to change

Twenty-three percent of bwin-Party's pro-forma revenues come from Germany (with half coming from sports and the other half divided between poker and casino). No detail is provided in terms of the percentage of group earnings coming from Germany, although we suspect that it is well above 23% given the higher margins enjoyed by (i) casino, (ii) unregulated markets (no taxes!) and (iii) Germany specifically, where both bwin and Party had significantly cut back on marketing spend over the last two years ahead of regulatory decisions. For Sportingbet, Germany accounts for just 4.4% of revenues with approximately 70% of that coming from sports-betting. For Playtech, Germany accounts for approximately 6% of revenues.

Greece

The good news is that the current draft legislation allows for all product verticals (sports, poker, casino and bingo). The less good news is that the proposed gross gaming revenue tax is high at 30%. The current draft legislation also bans betting exchanges (a similar ban exists in France at present). The timing of the passage of legislation could be delayed as the EU does not wish to fast-track the legislation.

Exposure to change

For Sportingbet, Greece accounts for 14.4% of revenues – so the introduction of such high taxes is material here. Seven percent of bwin-Party's pro-forma revenues come from Greece. For Betfair, we understand that Greece accounts for about 6% of group revenues currently. For Playtech, Greece accounts for just 3% of revenues.

Spain

The good news is that it appears Spain is moving towards regulating all product verticals. The proposed tax rate is 25% of gross gaming revenues. It is unclear exactly when legislation may be brought forward; however, in the bwin.Party presentation, the group said that it believed it was likely in H2 2011.

Exposure to change

For Sportingbet, Spain accounts for 12.9% of revenues. bwin-Party has not disclosed how big Spain is in terms of revenues, which implies that it is less than 5%. For Playtech, Spain accounts for just 3% of revenues.

Italy

Here the news is likely to be positive – the only real question is when? Italy is expected to finally introduce online casino (not slots) and poker cash games by end-June 2011. However, as this was originally scheduled for the beginning of 2010, investors are not holding their breaths at this stage. Any significant delays beyond June would impact consensus earnings for bwin.Party given its exposure here. It should also be noted that a legal dispute is ongoing between the Italian regulator (AAMS) and Betfair which could result in Betfair losing its Italian licence.

Exposure to change

For bwin-Party, Italy currently accounts for 6% of pro-forma synergies. For Sportingbet, it is believed to be less than 3%. For Betfair, Italy is believed to account for circa 6% of revenues.

France

Currently only sports-betting and poker are allowed by licensed operators in France with a ban on casino introduced in June 2010. The view (unsurprisingly) from all operators was that the current high tax regime on sports-betting is not working, a view shared by the regulator ARJEL. The government has said that it may make changes to the regulatory regime in 2012 following the presidential election at the end of April. Interestingly, while operators expressed optimism that taxes could be lowered and new products introduced, Patrice Rodrigue from Gambling Compliance poured cold water on this by suggesting that senior politicians remain opposed to such change.

Exposure to change

Paddy Power and bwin.Party would benefit if tax rates on sports-betting were introduced, while bwin.Party and Playtech would clearly be the big listed winners if casino was introduced.

Other EU markets

Belgium, Denmark and Holland are all moving to regulate their online markets. Belgium is currently limiting licences to land-based operators only (expect legal challenges), but the shape of the market otherwise (all products, 11-15% GGR tax) is encouraging. Denmark has passed its own legislation (all products with the exception of bingo, tax rate 20% GGR), but this is now subject to legal challenges from land- based operators contesting the low tax rates being applied vis-à-vis land-based rates. Resolution is expected in H2 2011. Holland is believed to be examining regulation, although no firm proposals have been published.

Exposure to change

None of the operators split out exposure to these countries but, given the size of the markets, it is unlikely that any individual market is overly material.

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