Tatts Group

February 2016

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Company Description

- Tatts Group (TTS) is a gaming conglomerate with an operational footprint in every state and territory of Australia and into the United Kingdom. The company has three related businesses that have significantly different operating models:
  - Lotteries – 60% FY15 EBIT
  - Wagering – 28% FY15 EBIT
  - Gaming – 12% FY15 EBIT
- The company has a market capitalisation of ~A$5.6bn[1]
- The Balance Sheet is in good shape with net debt of ~A$656m[2] and minimal other liabilities

1. Based on a closing share price of A$3.86 on 12 February 2016
2. Total debt (A$919m) plus prize reserve (A$159m) less cash (A$422m)

Our Investment Thesis

- The sum of Tatts Group parts is worth significantly more than the current market price
- The Wagering businesses has strategic corporate appeal and should be separated from the Group
- The Lotteries business has attributes that are very similar to infrastructure assets and should be valued accordingly
- A free standing Lotteries business requires a refreshed Board and management to focus on growth opportunities
- The Balance Sheet provides scope for capital management
- We believe the company is worth >A$5.50/share today if separated. If growth opportunities in Lotteries are pursued and value creative capital management options are undertaken, it could be worth more

Our Investment Thesis – Sum-of-the-Parts

- Tatts Group individual parts are worth significantly more than the current market price
- The table below does not ascribe any value for TTS $197m (13cps) of franking credits

	Basis	Multiple Range		Value	
Lotteries[1]	FY17 EBIT multiple	22.0	23.0	7,186.0	7,512.7
Wagering	FY17 EBIT multiple	12.0	14.0	1,597.4	1,863.6
Gaming[2]	FY17 EBIT multiple	10.0	12.0	394.7	473.6
Corporate/Other	FY17 EBIT multiple	10.0	12.0	(669.1)	(802.9)
Enterprise Value				**8,509.0**	**9,047.0**
less: Net debt				656.1	656.1
Equity Value				**7,852.9**	**8,390.9**
Shares on issue				1,460.8	1,460.8
Equity Value per share				**$5.38**	**$5.74**
Market price at 15-Feb-16				**$3.86**	

1. Assumes the Victorian Lottery Licence is renewed for 10 years at a cost of A$300m
2. Assumes the NSW Gaming Monitoring Licence is not renewed. Earnings have been removed accordingly

Wagering Demerger Superior to TAH Nil Premium Merger

- In November 2015, TTS announced that confidential discussions had taken place between itself and Tabcorp (TAH) regarding a nil-premium merger of equals (NPM), however the two parties were unable to agree on key transaction terms
- Whilst we see the logic in putting the two wagering businesses together, we believe current TTS shareholders should retain the crown jewel – the Lotteries business – unless TAH is willing to pay an appropriate premium, and this certainly wasn’t implied in the NPM
- We believe a demerger of the Wagering business is a far superior outcome for TTS shareholders than an NPM with TAH
- A demerger would also facilitate a competitive auction under the likely scenario that other parties have interest in owning TTS Wagering

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Wagering Demerger Superior to TAH Nil Premium Merger

- Based on comments following the disclosure of the NPM discussions, we believe TTS Board and Management had designs on creating a 'national champion' gambling conglomerate that would use its Balance Sheet to pursue opportunities in all forms of gaming in offshore markets
  - *"It would have positioned an Australian company at the forefront of the wagering space and it would have had the whole suite of products: wagering, gaming, lotteries. As the opportunities fell out around the globe, we would have been able to participate in a number at any one time. We would have been big enough to pursue multiple opportunities"* [1]
- We do not believe a combined TTS/TAH considering the acquisition of 'a number' of assets in offshore markets would be in the best interests of shareholders of either company

1. Quote from Robbie Cooke, *Tatts chief has unfinished business with Tabcorp,* Australian Financial Review, 12 December 2015

Wagering Demerger Superior to TAH Nil Premium Merger

- We believe TTS has a poor record of acquisitions outside of its core Lotteries competency:

1. TTS outlaid >A$350m to acquire the Talarius slot machine business in the U.K. In FY15, Talarius generated A$6m in EBIT, with ***cumulative EBIT barely breakeven since it was acquired***, an extremely poor return and in our view a waste of shareholder funds
2. TTS outlaid >A$2.2bn in debt and equity to acquire UNiTAB in 2006 for a high EBIT multiple of 17.4x. We estimate the acquired businesses have grown at a paltry rate of 2% per annum[1] and we expect this meagre growth rate to decline further as Wagering continues to struggle and the NSW Gaming Monitoring licence is renewed at lower profitability or lost to a competitor

1. In FY06, UNiTAB generated A$167m of EBITDA. In FY15, we estimate the equivalent businesses – TTS Wagering, Maxgaming and allocated Corporate – generated EBITDA of $201m. This includes >$30m of synergies that TTS claimed it achieved as a result of the acquisition

Wagering Demerger Superior to TAH Nil Premium Merger

- Given the track record of acquisitions, we question whether the current Board has the appropriate skill set
- The fact that the Board was willing to enter into discussions regarding a nil-premium merger with Tabcorp that substantially undervalues the crown jewel Lotteries business further erodes any confidence
- In contrast to its forays into Wagering in Australia and slot machines in the U.K., TTS successful acquisitions have been in its core Lotteries business
- These acquired businesses were operating successfully prior to acquisition and with their monopoly position and good management of costs by TTS, profitability has improved

Wagering Demerger Superior to TAH Nil Premium Merger

- The inherent strengths of the lotteries business model and the high regulatory barriers limiting competition ensure that it is difficult to diminish their profitability
- We believe that Wagering should be separated from TTS, and that TTS should then undertake Board and management renewal with a focus on the crown jewel Lotteries business

Wagering Demerger Superior to TAH Nil Premium Merger

TTS acquisitions	Year	Consideration (A$m)
Wagering (UNiTAB)	2006	
Shares Issued (558,585,825)		2,005.3
Cash paid		56.4
Net debt acquired		194.9
Total consideration		**2,256.6**
Estimated FY15 EBITDA		**200.7**
Talarius		
Original 50% investment	2007	94.3
Remaining 50% acquired	2008	63.5
Net debt acquired	2008	200.5
Total consideration		**358.2**
Estimated FY15 EBITDA		**16.4**
Lotteries		
Victorian Major Licence	2007	19.0
Golden Casket	2007	530.0
NSW Lotteries	2010	850.0
SA Lotteries	2012	427.0
Total consideration		**1,826.0**
Estimated FY15 EBITDA		**>300.0**

Source: Tatts Group, Sandon Capital analysis

- Tatts has outlaid A$1.8bn to acquire Lotteries licences since 2007. By our estimates, these acquisitions now contribute >A$300m in EBITDA
- In contrast, TTS has outlaid A$2.6bn acquiring UNiTAB and slots assets in the U.K. By our estimates, these acquisitions now contribute <A$220m in EBITDA and these earnings look set to reduce further in the future

LOTTERIES – 60% FY15 EBIT

Tattslotto

NSW Lotteries

Golden Casket

SA Lotteries

Lotteries Business Overview

- Tatts has operated regulated lotteries since 1897 and today is a licenced provider of lottery products in all Australian states except Western Australia[1]
- The business sells products through >4,200 agents and online. In FY15, online sales comprised 10.4% of total sales
- Tatts is the only lottery operator that has a proprietary technology system
- 47% of the Australian adult population played a lotto game in the last 12 months. Average spend per transaction is ~A$12.50
- The business contributes >A$500m in lottery taxes to state & territory governments

1. TTS doesn't own the licences in Queensland, South Australia and the Northern Territory. In Queensland, the company has an exclusive Lottery Operator Agreement. In South Australia and Northern Territory, Tatts has an agreement with the respective state government to exclusively manage the lottery

Infrastructure Assets vs Lottery Assets

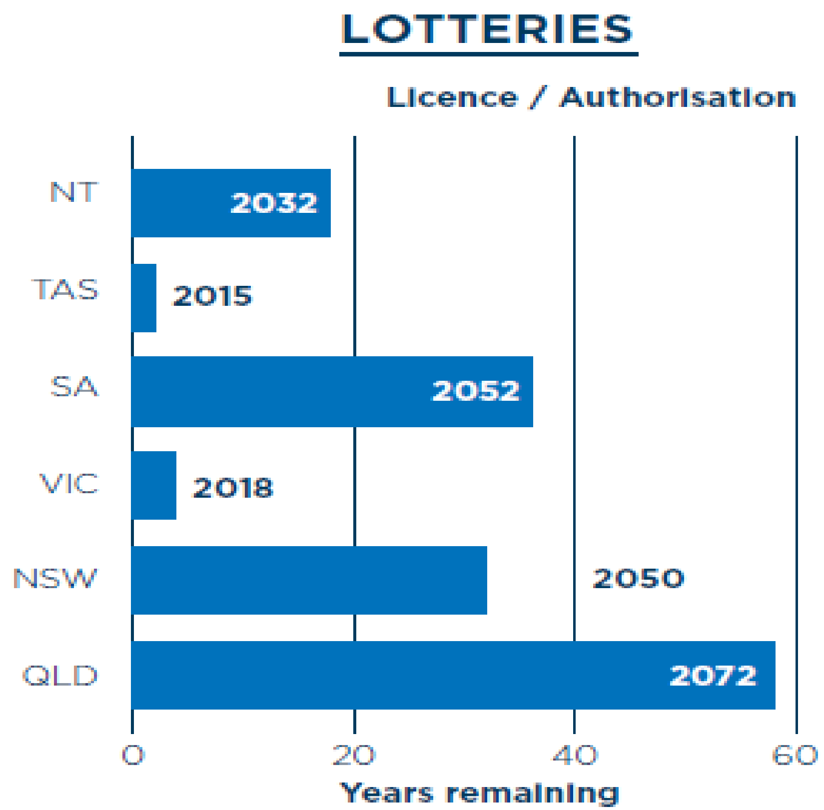
- Lottery concessions in Australia are state-based monopolies, very similar in structure to infrastructure concessions
- They have significant barriers to entry and provide a dominant market position for the owner
- They allow the owner to ***profitably*** operate a monopoly asset over a long duration (generally 40+ years) on behalf of a government
- The cash flows from lottery concessions have low economic sensitivity, are dependable and easily forecastable, and require very little capital investment to maintain
- An advantage of lottery concessions is that they are significantly less capital intensive to operate than infrastructure concessions

Infrastructure Assets vs Lottery Assets

	Infrastructure	Lotteries
Government authorised concession	✓	✓
Long dated licence authorisation	✓	✓
Monopoly asset	✓	✓
Large upfront capital requirements	✓	✓
Large ongoing capital requirements	✓	✗
Low economic sensitivity	✓	✓
Easily forecastable cash flows	✓	✓

Long Dated Concessions to run a Monopoly

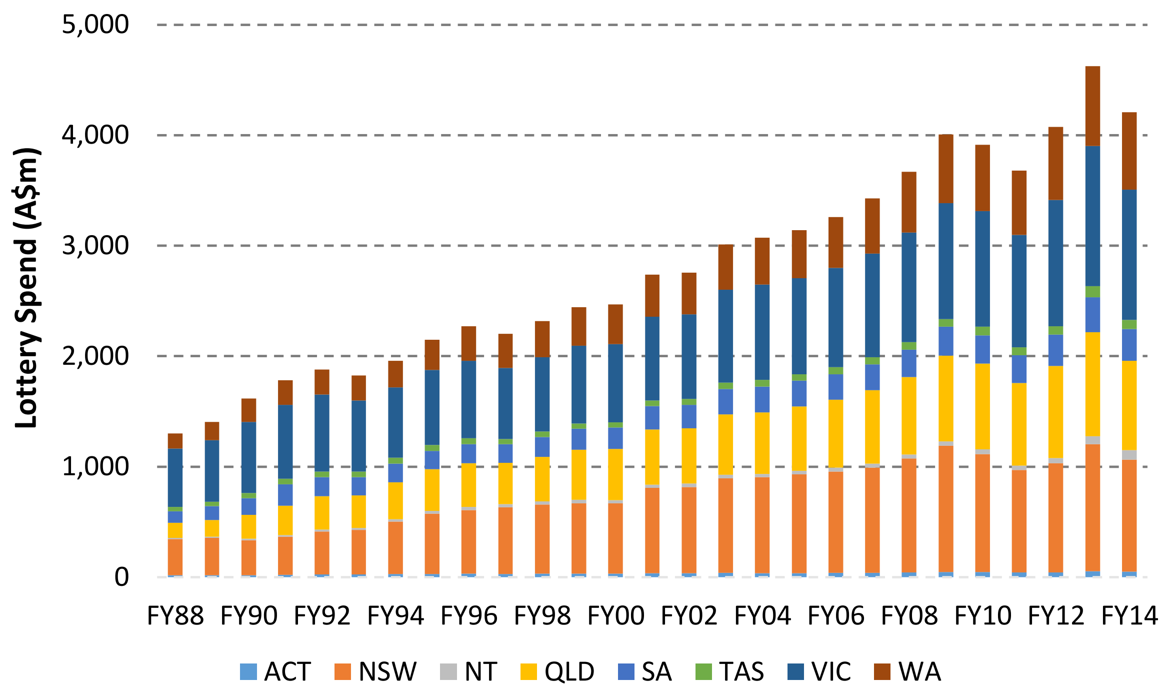
- Approximately 75% of TTS Lotteries EBIT comes from licences that run for at least 35 years



Source: Tatts Group

Lottery Spend is Consistent & Predictable

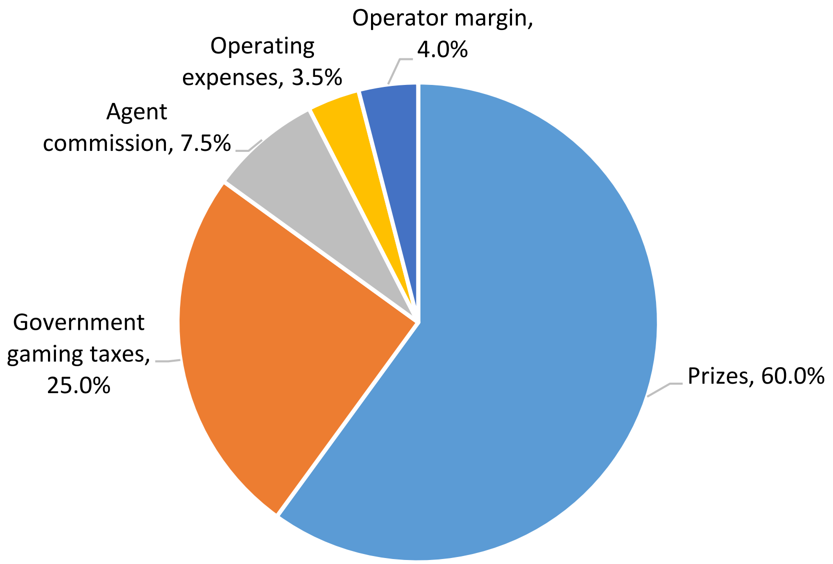
- The chart below shows lottery turnover by state in Australia since 1988. The cash flows from lottery concessions have low economic sensitivity, are dependable and easily forecastable



Source: Australian Gambling Statistics, 31st Edition

Lottery Regulators and Operators have Aligned Interests

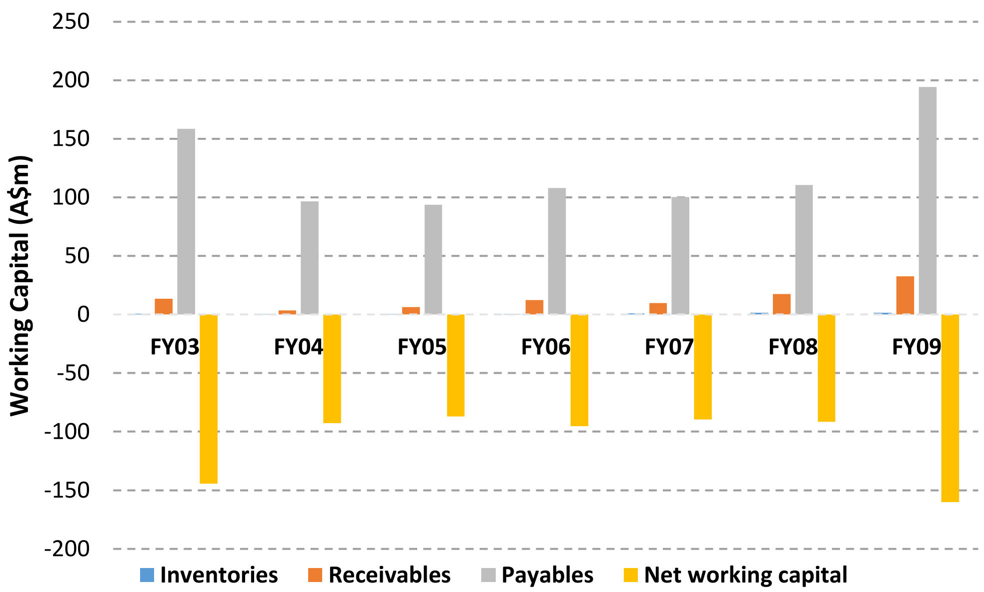
- The chart below shows the approximate distribution of $1 spent on a lottery ticket. The large amount of government taxes paid by concession holders ensures that the relationship between lottery regulator and the lottery operator is more like a partnership and both are incentivised to maximise lottery turnover



Source: NSW Lotteries, SA Lotteries and Golden Casket Annual Reports, Sandon Capital analysis and estimates

Lotteries are a Self Funding Business

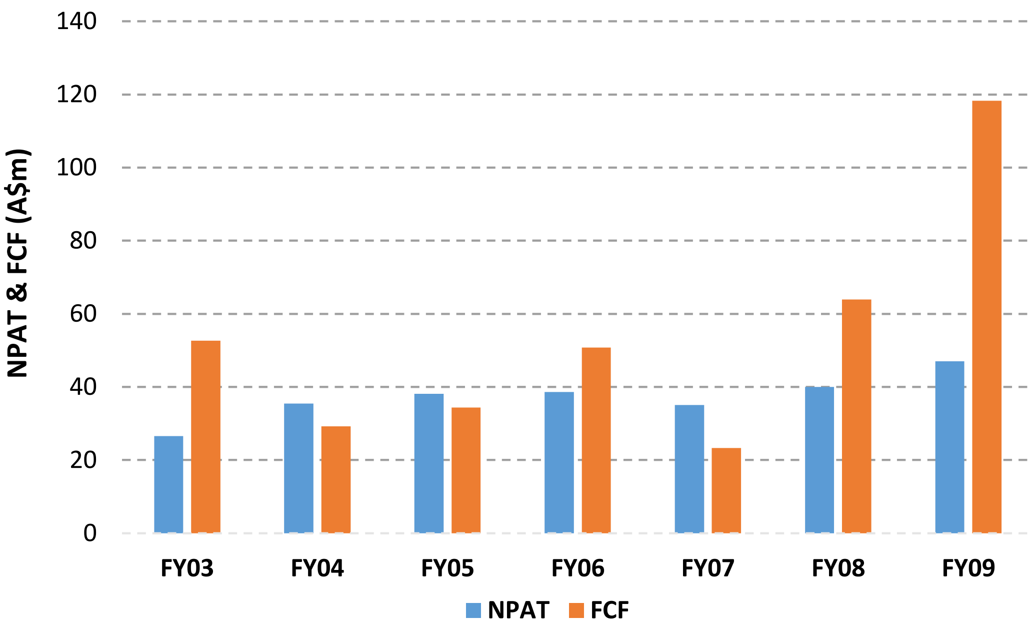
- Lottery operators hold lottery ticket proceeds – on which they earn interest – before prizes and government taxes are paid. This results in the business carrying negative working capital
- In FY09, the final year before acquisition by TTS, the NSW Lotteries business had a negative net working capital position of –A$160m



Source: NSW Lotteries, Sandon Capital analysis. Net working capital = inventory + receivables - payables

Lotteries are a Self Funding Business

- A chart of net profit after tax (NPAT) against free cash flow (FCF) highlights the same phenomenon
- From FY03 to FY09, NSW Lotteries generated $260m of NPAT. Over the same period, FCF was $373m, a cash conversion ratio of 143%



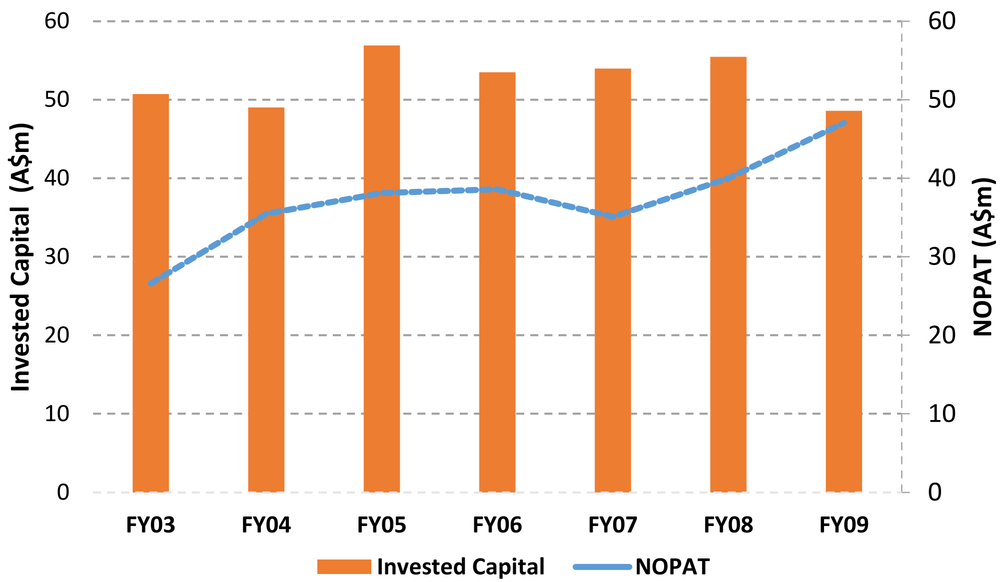
Source: NSW Lotteries, Sandon Capital analysis. FCF = operating cash flow – capital expenditure

Earnings Growth With Minimal Capital Investment

- Lotteries are one of the rare businesses that generate stable long term earnings growth with minimal ongoing capital requirements
- In general, stay-in-business capital expenditure runs below depreciation (of fixed assets) and amortisation (of upfront licence fees)
- Whilst not disclosed by TTS, we estimate annual capex for the Lotteries business to be A$15-20m, below annual depreciation and amortisation charges of A$26m
- Assuming all earnings are paid out as dividends, as historically has been the case when state governments operated lotteries, the capital base of the asset remains constant or even declines at the same time earnings and cash flow are increasing

Return on Invested Capital is Exceptional

- This feature of the lottery business is reflected in the financial profile of the NSW Lotteries business prior to acquisition by TTS
- In FY03, the business had invested capital (IC) of A$51m and generated net operating profit after tax (NOPAT) of A$26m. In FY09, the business had IC of A$49m and generated NOPAT of A$47



Source: NSW Lotteries, Sandon Capital analysis. NOPAT = EBIT – tax, IC = Equity + total debt - cash

Network Effect Provides Strong Barriers to Entry

- The 'network effect' for incumbent lottery providers is very powerful
- TTS has existing systems, infrastructure, technology and processes in place that must be replicated should a competitor wish to bid for a lottery licence in Australia
- With TTS holding all but one of the major lottery licenses in Australia, it is able to spread its fixed operating costs across a much larger revenue base, thereby achieving significant economies of scale
- This dominant position provides extremely high barriers to new entrants and limits the price a competing bidder can pay in a contested lottery tender
- This places TTS in an extremely powerful position to retain the Victorian lottery licence when it comes up for renewal in 2018, especially if the licence duration remains 10 years (relatively short), as we expect

Network Effect Provides Strong Barriers to Entry

- The renewal of the Victorian Lottery Licence in 2008 provides a case study of the network effect in lotteries providing strong barriers to entry
- In 2007, the Victorian Government split the previously exclusive lottery licence – operated by TTS – into two parts:
  - TTS was awarded the major licence for the operation of the state's lotteries where prize pools are combined with lottery operators in other Australian jurisdictions
  - Intralot was awarded the licence to sell instant 'scratch-it' games and daily keno
- After six years and A$63m of losses[1], Intralot abandoned its contract, with the Victorian government approving a variation to TTS licence to allow it to sell instant scratch-it games and daily keno
- Whilst not explicitly disclosed by TTS, comments in its FY15 result imply the sale of instant scratch-it games and daily keno in Victoria is once again profitable

Source: *Tatts to take over $50m scratchie contract in Victoria*, Sydney Morning Herald, 27 October 2014

Listed Infrastructure Comparisons Imply Significant Value

- We believe the characteristics of lottery concessions are at least equal, if not superior, to traditional infrastructure concessions. As such, we believe the TTS Lotteries business is significantly undervalued within the current TTS conglomerate structure
- Furthermore, recent transactions highlight the prices that private market participants are willing to pay for infrastructure assets. Chicago Skyway sold for 37x EBITDA in 2015[1], the Indiana Toll Road sold for 31x EBITDA in 2015[1] and the ports of Botany and Newcastle sold for 25x EBITDA in 2013[2]

	Price	Mkt Cap	EV	P/E			EV / EBITDA			EV / EBIT			Div Yield
				FY15	FY16	FY17	FY15	FY16	FY17	FY15	FY16	FY17	FY17
Transurban	10.74	21,789.3	34,142.3	nmf	68.0	53.7	28.2	24.9	21.6	51.7	44.7	36.4	4.4%
Sydney Airport	6.38	14,224.2	21,556.9	94.0	55.5	48.5	22.0	20.3	18.8	32.3	28.9	26.3	4.4%
Macquarie Atlas	4.18	2,163.2	5,693.2	31.4	13.4	14.7	12.3	10.8	9.9	14.3	12.4	11.2	4.5%

Source: Bloomberg, Sandon Capital estimates. Sandon uses proportionately consolidated earnings and balance sheet items for TCL and MQA

1. *Another day, another eye-popping tollroad multiple*, Australian Financial Review, 17 November 2015
2. *Ports sale adds $4.3b to coffers for key projects*, Sydney Morning Herald, 13 April 2013

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Listed Infrastructure Comparisons Imply Significant Value

- We believe the best method to value the TTS Lotteries business is to use similar metrics that investors use to value infrastructure assets:

1. Dividend Yield
2. Discounted Cash Flow

- Both of these methods imply output EV/EBIT multiples of 22-23x, resulting in a calculated enterprise value for the Lotteries business of A$7.4-7.5bn
- The assumptions and calculations behind our assessed value are discussed in the following pages

Listed Infrastructure Comparisons Imply Significant Value

1. Dividend Yield

- Infrastructure companies currently trade on FY17 dividend yields of 4.4 - 4.5%. However due to their stapled structure, they pay minimal cash tax in Australia, and therefore their dividends carry little to no franking[1], making the dividends inefficient from a tax perspective for Australian investors
- As TTS Lotteries generates 100% of its earnings and pays 100% of its cash tax in Australia, we believe the net yield should be grossed up for the franking credits that are generated
- Hence a fully franked yield of 3.0% is equivalent to an unfranked yield of 4.3%, which is a similar yield to which infrastructure companies trade

1. For investors not familiar with Australia's Dividend Imputation System, a brief summary can be found at www.frankingcredits.com.au, with further information at www.ato.gov.au

Listed Infrastructure Comparisons Imply Significant Value

1. Dividend Yield

- Using the following assumptions for TTS Lotteries business:
  - FY17 EBITDA of A$353m, D&A of A$26m
  - Leverage (net debt / EBITDA) of 2.5x – equals net debt of $882m, moderate given the strong cash flows from lottery assets
  - Interest rate of 3.25% – consistent with TTS last debt raising at BBSW + 90-130bps
  - Tax rate of 30% – Australian corporate rate
  - A$300m to renew the Victorian Lotteries licence
- We calculate a standalone Lotteries business would earn NPAT of A$209m in FY17
- Applying a fully franked dividend yield of 3.0%, and subtracting A$300m for the cost to renew the Victorian lottery licence, translates to an enterprise value for TTS Lotteries of A$7.5bn

Listed Infrastructure Comparisons Imply Significant Value

1. Dividend Yield

- This equates to an EV/EBIT multiple of 23x which compares favourably to listed infrastructure companies trading at EV/EBIT multiples of 27 – 36x, despite their higher capital intensity
- Given our premise that TTS Lotteries deprecation & amortisation is less than capital expenditure and extra cash would be provided by working capital, TTS Lotteries would fund its dividend from free cash flow
- Over time, the balance sheet would de-lever as free cash flow exceeds earnings. This would allow growth initiatives or additional capital management initiatives to be undertaken
- In contrast, Transurban and Sydney Airports have been funding their dividends out of debt and equity issues for quite some time

Transurban Funding Dividend from Debt & Equity Raisings

- Transurban (TCL) free cash flow versus dividends paid since FY09
- Over that period, A$250m of FCF has been generated whilst A$2.9bn of dividends have been paid
- Excluding intangibles, FCF is still only A$1.6bn

Year ended 30 June, A$m	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Operating Cash Flow	320.0	333.4	374.7	373.2	411.3	521.0	304.0
Distributions from equity accounted investments	45.5	36.5	41.0	53.5	50.0	57.0	95.0
Distributions to non-controlling interests	(32.9)	(28.2)	(15.5)	(14.9)	(9.9)	(9.0)	(57.0)
Payments for equity accounted investments	(32.5)	(24.8)	(29.4)	(18.3)	(207.8)	(39.0)	(2.0)
Capex	(198.8)	(46.8)	(36.6)	(41.8)	(17.5)	(73.0)	(77.0)
Payments for Intangible Assets	(87.1)	(56.1)	(797.7)	(262.3)	(234.5)	(112.0)	(203.0)
Free Cash Flow	**14.3**	**214.0**	**(463.6)**	**89.4**	**(8.4)**	**345.0**	**60.0**
Total Dividends	(459.1)	(295.9)	(357.1)	(412.6)	(445.4)	(484.0)	(713.0)
Dividend Funding Deficit	**(444.8)**	**(81.9)**	**(820.7)**	**(323.1)**	**(453.8)**	**(139.0)**	**(653.0)**
Dividends settled in securities	286.4	65.4	124.6	76.0	34.6	64.0	143.0
Net proceeds from borrowings	81.8	23.4	428.5	150.2	284.8	736.0	4,201.0
Proceeds from issue of stapled securities	10.0	530.9	0.0	0.0	100.0	2,696.0	0.0

Source: Transurban, Sandon Capital analysis

Sydney Airports Funding Dividend from Debt Raisings

- Southern Cross Airports Corporation Holdings Limited – the parent company of Sydney Airports (SYD AU) – free cash flow versus dividends paid since FY09
- Over that period, A$1.5bn of FCF has been generated whilst A$2.8bn of dividends have been paid.
- Net debt has risen steadily over the period analysed

Year ended 31 December, A$m	CY09	CY10	CY11	CY12	CY13	CY14	1HCY15
Operating Cash Flow	309.7	437.4	416.0	468.4	511.9	590.7	279.8
Capex (inc. capitalised borrowing costs)	(310.0)	(136.6)	(171.6)	(210.4)	(236.1)	(261.7)	(142.9)
Free Cash Flow	**(0.2)**	**300.8**	**244.4**	**258.0**	**275.8**	**329.0**	**136.9**
Total Dividends	(300.9)	(399.5)	(383.9)	(450.1)	(472.8)	(522.8)	(279.8)
Dividend Funding Deficit	**(301.1)**	**(98.7)**	**(139.5)**	**(192.1)**	**(197.0)**	**(193.8)**	**(142.9)**
Net Debt	5,380.4	5,523.6	5,716.8	5,923.6	6,370.3	6,950.0	7,107.1

Source: Southern Cross Airports Corporation Holdings Limited , Sandon Capital analysis

Listed Infrastructure Comparisons Imply Significant Value

2. Discounted Cash Flow

- Using the following assumptions for TTS Lotteries business:
  - Earnings consistent with the previous example with EBIT growing at 6.0% per annum for 3 years off the FY17 base, and then at a terminal rate of 3% thereafter
  - Annual capex of $17.5m p.a.
  - Leverage, interest and tax rates consistent with the previous example
  - A discount rate of 6.25% – a premium to what we estimate the Australian equity market is using to value infrastructure assets. This discount rate is also significantly above the Australian 10-year government bond rate of ~2.4%
  - A$300m to renew the Victorian Lotteries licence
- We calculate the enterprise value of the Lotteries business to be A$7.4bn, equating to an EV/EBIT multiple of 22.5x
- We expect a DCF is the methodology used by pension funds who have purchased lotteries assets to match their long duration liabilities

Lotteries Are Well Understood by Offshore Investors

- Canadian pension funds are large shareholders in listed and unlisted Australian infrastructure assets. They are also owners of Lotteries assets
- Ontario Teachers Pension Plan (OTPP) purchased Camelot, the operators of the UK National Lottery, for £389m in 2010
- Camelot was part of a consortium that purchased the licence to run Ireland's National Lottery
  - The consortium acquired a 20 year licence for €405m in February 2014
- OTPP was the under bidder to TTS for the NSW Lotteries licence in 2010
- ***If Australian investors don't re-rate TTS Lotteries business, we believe international investors will***

Lotteries Growth Opportunities

- Organic growth in TTS Lotteries business has been driven by consistent growth in demand for lottery tickets and solid cost control. In our opinion, TTS has done a poor job driving top line growth in the business and believe there are several opportunities to augment earnings:

1. Increase online penetration
2. Decrease the odds of winning division 1 to increase jackpot size
3. Examine whether a regional lottery bloc is feasible

- With technology disrupting many industries, we believe it important that TTS looks at ways to take the lead on technology, thereby fortifying its Lotteries business

Lotteries Growth Opportunities

1. Increase online penetration

- At its last result, TTS noted that online sales comprised 10.4% of its total lottery ticket sales
- This is significantly less than other parts of the world with online sales in the UK at 18.4%[1] and Finland at ~30%[2]
- Whilst figures for the UK and Finland are boosted by online sales of scratch-it tickets – scratch-its are only sold over the counter in Australia – we believe it highlights the significant opportunity for increased online sales for TTS in Australia
- We believe an increasing proportion of tickets sold digitally will have benefits for both the top and bottom line

1. Camelot UK Lotteries Ltd FY15 Annual Report 2. Jumbo Interactive Ltd FY15 Annual Report

Lotteries Growth Opportunities

1. Increase online penetration

- The benefits of selling more tickets digitally are threefold:
  1. Transaction values are higher. A$14.65 digital average spend vs A$12.65 overall average spend per transaction in 1H15[1]
  2. Costs are lower as the 7.5%+ agent commission is not required to be paid
  3. Increased sales of tickets to a younger demographic who prefer the convenience of buying tickets online[2]
- We estimate that ~25% of TTS online lottery sales are currently through a third party, Jumbo Interactive (JIN)
- JIN controls the www.ozlotteries.com domain and also has an app for mobile devices

1. TTS 1H FY15 result presentation 2. Roy Morgan Research Single Source Lottery Players Profile Australians 18+ Apr13 - Mar14

Lotteries Growth Opportunities

1. Increase online penetration

- JIN sells the same TTS lottery tickets for a 10%+ premium[1]
- Whilst this highlights the pricing power that lottery operators and resellers have, we think it is detrimental to the TTS brands
- We also believe it highlights a failing of TTS to properly develop its own digital strategy for selling tickets
- When TTS agreement with JIN for South Australia and Northern Territory expires in September 2017, we believe all future digital sales should go through TTS channels rather than through third parties
- In the meantime, TTS should be focused on further developing its own digital strategy

1. Based on online comparisons between ozlotteries.com.au and tatts.com across various Powerball, Ozlotto and Tattslotto draws

Lotteries Growth Opportunities

2. Decrease the odds of winning division 1 to increase jackpot size

- Lottery ticket sales increase significantly as jackpot size increases
- TTS management uses an arbitrary A$15m jackpot as a guide for when lottery ticket sales increase meaningfully
- The table below highlights the odds of winning each of the various lottery games offered by TTS

Game	Division 1 Requirement	Odds to Win Division 1
Tattslotto	6 winning numbers	8,145,060:1
Oz Lotto	7 winning numbers	45,379,620:1
Monday & Wednesday Lotto	6 winning numbers	8,145,060:1
Powerball	6 winning numbers + Powerball	76,767,600:1
The Pools	6 winning numbers	2,760,681:1

Source: https://tatts.com/tattersalls/about/odds-of-winning

Lotteries Growth Opportunities

2. Decrease the odds of winning division 1 to increase jackpot size

- TTS restructured Oz Lotto in October 2005 to increase the probability of winning a prize, and also decrease the probability of winning Division 1 – from 1:8,145,060 to 1:45,379,620
- Whilst acquisitions make calculations difficult, the growth rate in Oz Lotto sales appears to be significantly faster than other products in the years following the restructure
- Powerball was restructured in March 2013 to increase the probability of winning a prize – from 1:120 to 1:78 – and also decrease the probability of winning Division 1 – from 1:54,979,155 to 1:76,767,600. A price increase was also implemented at the time of the restructure

Source: Tatts Group, Sandon Capital analysis

Lotteries Growth Opportunities

2. Decrease the odds of winning division 1 to increase jackpot size

- TTS ceased reporting major product revenue with its FY12 result, hence it is impossible to determine the impact the restructure had on Powerball sales
- In FY12, the last year of product revenue reporting, the sales of Saturday Lotto were more than Oz Lotto and Powerball combined, making it easily TTS most popular product
- We believe a restructure of Saturday Lotto to increase the probability of winning a prize whilst decreasing the probability of winning Division 1, thereby increasing jackpot size, would be a good way to drive growth in the product. Prices could also be increased at the same time
- Like the relaunch of Powerball, a significant jackpot (A$75m+) would be a good way to kick off the refreshed Saturday Lotto product

Lotteries Growth Opportunities

3. Examine whether a regional lottery bloc is feasible

- In the early 2000's, sales for the U.K. lottery stagnated and started to decline. In 2004, the U.K., French and Spanish lottery operators established EuroMillions with the three countries forming a lottery bloc to pool prizes and offer larger jackpots
- Whilst early sales were slow, ticket sales grew significantly and made a significant contribution to the >50% sales increase seen by U.K. Lottery Operator, Camelot, from 2003 to 2013. Other countries in the EuroMillions lotto bloc have also seen strong growth in lottery revenue
- Today, there are 13 countries involved in the EuroMillions lottery bloc and EuroMillions sales comprise ~30% of Camelot's total sales. Key to the demand for EuroMillions has been consumer demand for larger jackpot sizes

Source: Camelot, Sandon Capital analysis

Lotteries Growth Opportunities

3. Examine whether a regional lottery bloc is feasible

- We believe Tatts should examine whether a Pan Asian lottery bloc is feasible in order to drive future revenue growth
- Whilst there are cultural, regulatory and financial (currency) hurdles, the establishment of EuroMillions proves that these are not insurmountable
- The obvious countries to form a regional lottery bloc are those that have a monopoly operator, a mature lottery market and a similar time zone
- The countries that fit this profile are Singapore (~A$5bn annual lottery turnover), Hong Kong (~A$1.4bn annual lottery turnover) and New Zealand (~A$900m annual lottery turnover)
- By way of comparison, annual lottery turnover in Australia is ~A$4.4bn

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Lotteries Growth Opportunities

3. Examine whether a regional lottery bloc is feasible

- As demonstrated in EuroMillions, but also in TTS own experience where it has restructured lottery products to increase jackpot size, a Pan Asian lottery product would be attractive to consumers and help drive revenue and earnings growth for TTS Lotteries
- Whilst the hurdles to implementing this product are not insignificant and would take considerable time to address – EuroMillions took 10 years from first discussion to implementation – we believe the opportunity is one worth pursuing
- To date, we have not heard any commentary from TTS on this opportunity

WAGERING – 28% FY15 EBIT

UBET

Keno

RadioTAB

Wagering Business Overview

- TTS Wagering (UBET) is a licensed provider of totalisator and fixed odds betting services through exclusive licences held in Queensland, South Australia, Northern Territory and Tasmania
- The company controls >1,300 sites – TABs, agencies and race clubs – and also offers wagering through other channels such as telephone and online
- In FY15, there were >300m total bets placed through TTS Wagering, with 65% by value through retail outlets, 26% online, 6% by phone and 3% on-course
- The business has struggled over the past few years as we believe it has been slow to adapt to the significant changes that have occurred in the Australian wagering industry

Source: Tatts Group, Sandon Capital analysis

Significant Changes In Wagering Industry

- The Australian wagering market has seen significant change in the past 5+ years. New entrants – corporate bookmakers – have taken advantage of lower tax jurisdictions and have ramped up marketing and product spend to take share from incumbents
- Strong customer demand for online wagering, fixed odds wagering and sports wagering has also benefited the corporate bookmakers
- The market has seen strong growth as a result of the new entrants satisfying the changing demands of customers, however the incumbents have seen their market share erode
- TTS in particular has been slow to adjust to the structural changes and has seen Wagering revenue ***decline*** by 2% and 1.5% in the past two years despite growth of 6%+[1] seen in Australian wagering markets

1. Gambling Turnover – Thoroughbred Racing, Harness & Greyhound Racing and Sports Betting, Racing Australia 2014/2015 Fact Book

Significant Changes In Wagering Industry

- Whilst TAH has been exposed to the same industry trends as TTS, it has adapted much better to the changed environment. Unlike TTS, TAH saw revenue and EBITDA growth in FY14 and FY15 and this trend continued at its 1HFY16 result
- We believe the key differences between TAH and TTS are:
  1. TAH has invested significantly more in its product
  2. TAH is much better positioned online and on mobile devices
  3. TAH has a much broader suite of products and content with which to engage the customer
  4. TAH has more of a corporate bookmaking mentality and is more entrepreneurial
  5. TAH has brand consistency. TTS Wagering business is up to its third brand (UBET) in the past five years
- Given TAHs superior operating performance, we believe there are numerous opportunities for them to improve TTS Wagering business

Further Industry Rationalisation is Likely

- A merger between Tabcorp and TTS Wagering has long been speculated, and synergies would be material
- We believe the synergies would be at least A$60m p.a. across:
  - Sales & Marketing
  - IT
  - Labour & Administration
- A combined business would allow the incumbents to fight back against the corporate bookmakers through increased scale and would also bring TAHs superior operating performance to an underperforming TTS Wagering business
- We also believe that the corporate bookmakers could be acquirers of TTS Wagering business making a competitive auction for the business likely

TTS Resistance to Wagering Demerger / Sale

- To date, TTS has resisted spinning off or selling its Wagering business despite pressure from some shareholders
- The company has stated it would prefer to improve the business before selling it. Given the poor ongoing performance of the TTS Wagering business, we question whether the current management team has the capacity to drive that improvement
- TTS also claims that there are IT synergies from having a conglomerate gaming structure. Given TTS has been behind the pack with its digital strategy for its Wagering business and has partly relied upon third parties to grow its Lotteries business online, we find this reasoning difficult to comprehend
- It is also possible that the Board and management might simply prefer a larger company than a smaller one

GAMING – 12% FY15 EBIT

Maxgaming

Talarius

Bytecraft

Maxgaming Overview

- Maxgaming is a centralised gaming machine monitoring system and services provider to almost 131,000 gaming machines in over 3,700 venues in New South Wales, Queensland and the Northern Territory
- In FY15, revenue was split 55% Monitoring, 23% Value Added Services and 22% Electronic Gaming Machine Maintenance. The business generated 11% of company EBIT in FY15
- In Queensland, Maxgaming operates under a competitive licence and has one key competitor in the monitoring space. Market share for monitoring is consistently around the 80% mark and monitoring comprises gaming machines in both licenced clubs and hotels.
- In Northern Territory, Maxgaming operates under a competitive licence, however is currently the only licenced monitoring operator in the state that is offering monitoring services

Maxgaming – Risk from Renewal of NSW Monitoring Licence

- In New South Wales, Maxgaming operates under an exclusive monitoring licence, resulting in the monitoring of 100% of the gaming machines that exist outside of the casino (licenced clubs and hotels)
- In addition to the monitoring of gaming machines, Maxgaming also has the exclusive licence to administer the New South Wales market "State Wide Link Jackpots"
- In November 2016, the exclusive New South Wales monitoring licence expires and is currently subject to a competitive tender
- We estimate this licence currently generates ~A$25m EBIT for TTS and believe it will be renewed at lower profitability or lost to a competitor
- In our valuation, we have assumed the licence is lost completely and have removed earnings accordingly

Talarius – Poor Acquisition that has Struggled from Day 1

- Talarius is a slot machine operator in the United Kingdom, operating 7,599 gaming machines in 164 gaming venues. The business generated 1% of Group EBIT in FY15
- The UK gaming machine licencing framework is different to Australia, in that any suitable, responsible operator can apply for and receive a gaming machine licence from the UK Gambling Commission
- TTS bought an initial 10.4% stake in Talarius in 2006 and increased its ownership to 50% in 2007 in a joint venture arrangement with Macquarie. The remaining 50% was purchased in January 2008 with total investment coming to >A$350m, including acquired debt
- In FY15, Talarius generated A$6m in EBIT, with ***cumulative EBIT barely breakeven since it was acquired***, an extremely poor return and in our view a waste of shareholder funds

Bytecraft

- Bytecraft provides technical support services in the gaming, wagering, lottery, retail, information technology and banking sectors, and is Australia's largest independent 24/7 service provider
- Since inception in 1989, Bytecraft's core business has been the provision of Technology Services in the Gaming sector, namely onsite maintenance, workshop repair, warehousing and distribution, and helpdesk services
- The business directly supports more than 59,000 electronic gaming machines, Australia wide. In addition to this, Bytecraft plays a role in the support of casinos in both Perth and Melbourne
- The business generated 0.1% of Group EBIT in FY15

Capital Management

- TTS Balance Sheet is in good shape. Net debt as of 30 June 2015 was ~A$656m, allowing significant scope for capital management
- TTS has stated that no capital management initiatives will be conducted until all appeals have been concluded in the Victorian Pokies Compensation Case
- The State of Victoria's Appeal to the High Court was concluded on 11 November 2015. We expect a final decision to be handed down in the first half of 2016
- To date, four lower court judges have ruled in TTS favour. TTS requires three out of the five appeal panel judges to rule in its favour in the High Court for a successful outcome

Capital Management

- Assuming the Victorian Pokies Compensation is retained, we expect TTS to be bold with its capital management plans
  - A$540m (compensation + interest) – tax (not yet disclosed)
- We believe the company can comfortably outlay A$600m – >10% of current market capitalisation – for capital management purposes without impacting its strong credit standing
- Available franking credits and retained earnings could allow the payment of fully franked dividends of up to A$0.095/share
- Another alternative is a buyback of 10% of shares outstanding
- We believe a combination of the two – through an off market, equal access buyback with a dividend component – is the most accretive to per-share value and therefore the best outcome for shareholders

Financials – Balance Sheet

ASSETS	
Current assets	
Cash	421.6
Receivables	80.6
Inventories	3.7
Other current assets	50.1
Total current assets	**556.1**
Non-current assets	
PP&E	210.2
Goodwill	3,650.5
Licences	598.6
Other intangibles	403.5
Other non-current assets	106.5
Total non-current assets	**4,969.3**
Total assets	**5,525.3**
LIABILITIES	
Current liabilities	
Payables	598.5
Short-term debt	333.2
Other current liabilities[1]	633.1
Total current liabilities	**1,564.8**
Non-current liabilities	
Long-term debt	585.4
Deferred tax	208.2
Other non-current liabilities	195.9
Total non-current liabilities	**989.4**
Total liabilities	**2,554.3**
Total Equity	**2,971.1**

Source: Tatts Group

1. Other current liabilities includes $540.5m of unearned income related to compensation from the State of Victoria

Valuation

Share price	3.86				
Shares on issue	1,460.8				
Market Capitalisation	5,638.7				
Net Debt	656.1				
EV	6,294.8				
NTA	(1.15)				
Multiples	**FY12**	**FY13**	**FY14**	**FY15**	**FY16E**
EV / Revenue	1.6	2.1	2.2	2.2	2.1
EV / EBITDA	9.7	12.8	12.6	12.4	12.0
EV / EBIT	11.5	15.5	15.2	15.0	14.4
P / E	16.2	23.5	24.2	21.8	20.9
FCF Yield	5.8%	4.9%	3.6%	6.0%	4.8%
Dividend Yield					4.4%

Source: Sandon Capital analysis

Key Business Risks

- Licence renewals
  - Victorian Lotteries Licence (June 2018)
  - New South Wales Centralised Gaming Machine Monitoring Licence (November 2016)
- Regulation and changes to regulation
- Taxes and levies
- Increased competition, especially in the wagering market
- Technology
  - Existing in house systems
  - Disruption to existing business model from new technologies
- Victorian Pokies Licence Compensation payment
- General economic fluctuations, including interest rates and currencies
- Merger and Acquisition activity

Sandon Capital Team

Gabriel Radzyminski – Portfolio Manager

Gabriel established Sandon Capital in 2008 after having devised and managed a number of successful investment funds for a leading high net worth wealth management firm. Sandon Capital has successfully invested its funds on behalf of wholesale clients, and advised shareholders, in a variety of listed companies, funds and trusts that have benefited from its activist investment strategy. Gabriel is currently Chairman of Sandon Capital Investments Limited, is an executive director of Mercantile Investment Company Ltd and a non-executive director of Chesser Resources Ltd, Future Generation Investment Company Ltd and Ask Funding Ltd.

Campbell Morgan – Analyst

Campbell joined Sandon in 2014 and has 14 years of experience in both Australian and International financial markets. Prior to joining Sandon, Campbell managed a Global Materials portfolio for Millennium, a New York based hedge fund with >US$30bn under management. Preceding this he was a Senior Analyst for a Global Industrials portfolio at Citadel Investment Group, a US$25bn Chicago based hedge fund. Campbell started his career in Australia, working in the Investment Bank at ANZ and after that as an Equity Research Analyst for Merrill Lynch before moving overseas in 2007 to work in Funds Management.

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