

Tatts Group (TTS.AX / TTS AU)

DECREASE TARGET PRICE

Rating	UNDERPERFORM
Price (02-Mar,A\$)	3.74
Target Price (A\$)	(from 3.45) 3.30
Target price ESG risk (%)	0.0
Market cap (A\$m)	5,477.3
Yr avg. mthly trading (A\$m)	313.2
Projected return:	
Capital gain (%)	-11.8
Dividend yield (net %)	4.8
Total return (%)	-7.0

*Stock ratings are relative to the relevant country benchmark.

*Target price is for 12 months.

Research Analysts

Larry Gandler

61 3 9280 1855

larry.gandler@credit-suisse.com

Ben Levin

61 3 9280 1766

ben.levin@credit-suisse.com

Vic Pokies refund out, NSW monitoring in

- **Tatts was unsuccessful in retaining its A\$540mn pokies licence refund** after the High Court upheld the Victorian Government appeal. Tatts must also pay 20 months of accrued interest and legal costs which we estimate to be A\$50mn.
- **NSW monitoring contract to 2032 extension announced last week.** Upgrade 3% 2018 EPS. We previously terminated this earnings stream in 2017 assuming Tatts either lost the contract, or terms would be less favourable. Terms: A\$209mn licence payment and capex on a new monitoring system.
- **Net valuation impact 15cps.** We also removed our special dividend expectation.
- **A potential WA TAB acquisition may now require equity funding.** Assuming maximum leverage of 3x net debt to EBITDA, Tatts may only have debt capacity of A\$500mn relative to a potential A\$700mn+ price for the WA TAB. Moreover, Tatts would probably need to re-negotiate its existing bank facilities with its debt headroom now reduced to about A\$300mn. In the absence of an acquisition, Tatts is comfortably geared at 2.3x.
- **Tatts continues to trade above fair value,** the implied multiple on the lottery segment is 16x FY17 EBITDA, a little too expensive for our liking.
- **Our DCF based target price falls to A\$3.30 (from A\$3.45)** with the benefit of the NSW monitoring contract, more than offset by the loss of Pokies Licence refund.

Total return forecast in perspective



Source: Company data, Thomson Reuters, IBES, Credit Suisse estimates

Performance	1M	3M	12M
Absolute (%)	-9.66	-13.02	-6.27
Relative (%)	-9.22	-9.07	9.12

Financial and valuation metrics

Year	6/15A	6/16E	6/17E	6/18E
Revenue (A\$ mn)	2,920	3,087	3,184	3,280
EBITDA (A\$ mn)	507	523	550	572
EBIT (A\$ mn)	420	437	462	481
Net Income (Adj.) (A\$ mn)	256	270	276	284
EPS (Adj.) (A\$)	0.18	0.18	0.19	0.19
Change from previous EPS (%)	n.a.	(1.6)	0.4	3.2
EPS growth (%)	10.5	4.4	1.9	2.7
Consensus EPS (A\$)	0.18	0.19	0.20	0.21
P/E (x)	21.2	20.3	19.9	19.4
Dividend (A\$)	0.17	0.18	0.18	0.18
Dividend yield (%)	4.4	4.8	4.8	4.8
Price/Book (x)	1.8	1.8	1.8	1.8
Net debt/EBITDA (x)	1.3	2.3	2.3	2.3

Source: Company data, Thomson Reuters, Credit Suisse estimates

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Figure 1: Financial Summary

Tatts Group (TTS)						Year ending 30 Jun						
Share Price: A\$3.74						02-Mar-2016						
Rating						UNDERPERFORM						
Target Price						A\$ 3.30						
vs Share price						%						
						-11.76						
<p>Tatts Group is an Australia-based company. It is engaged in the operation of licensed gaming machines, conducting wagering and sports betting, conducting gaming machine monitoring and supply of jackpot and other services.</p>												
Profit & Loss						06/14A	06/15A	06/16E	06/17E	06/18E		
Sales revenue	2,868.9	2,919.9	3,087.0	3,184.3	3,280.1							
EBITDA	498.4	507.4	523.4	550.2	572.3							
Depr. & Amort.	83.9	87.1	86.9	88.3	91.1							
EBIT	414.5	420.3	436.5	461.9	481.3							
Net interest	87.9	54.2	47.7	65.4	72.6							
Reported PBT	326.6	366.1	388.8	396.5	408.7							
Income tax	100.0	110.3	118.6	120.9	124.6							
Profit after tax	226.6	255.8	270.2	275.6	284.0							
Associates	0.0	0.0	0.0	0.0	0.0							
Minorities	0.0	0.0	0.0	0.0	0.0							
Normalised NPAT	226.6	255.8	270.2	275.6	284.0							
Analyst adjustments	0.0	0.0	0.0	0.0	0.0							
Unusual item after tax	-26.2	-3.8	-40.8	0.0	0.0							
Reported NPAT	200.4	252.0	229.5	275.6	284.0							
Balance Sheet						06/14A	06/15A	06/16E	06/17E	06/18E		
Cash & equivalents	583.3	259.1	263.2	220.1	226.3							
Inventories	8.2	3.7	3.9	4.0	4.1							
Receivables	132.5	80.6	82.8	84.1	85.3							
Other current assets	187.0	212.6	220.5	226.2	231.4							
Current assets	910.9	556.1	570.4	534.4	547.1							
Property, plant & equip.	205.6	210.2	251.6	435.4	591.1							
Intangibles	4,540.0	4,652.5	4,609.5	4,566.6	4,523.6							
Other non-current assets	43.6	106.5	106.5	106.5	106.5							
Non-current assets	4,789.2	4,969.3	4,967.6	5,108.4	5,221.1							
Total assets	5,700.2	5,525.3	5,538.0	5,642.8	5,768.3							
Payables	591.0	598.5	632.8	652.7	672.2							
Interest bearing debt	1,359.3	925.2	1,450.0	1,500.0	1,560.0							
Other liabilities	913.8	1,030.5	489.5	489.5	489.5							
Total liabilities	2,864.1	2,554.3	2,572.3	2,642.2	2,721.7							
Net assets	2,836.0	2,971.1	2,965.8	3,000.7	3,046.6							
Ordinary equity	2,836.0	2,971.1	2,965.8	3,000.7	3,046.6							
Minority interests	0.0	0.0	0.0	0.0	0.0							
Preferred capital	0.0	0.0	0.0	0.0	0.0							
Total shareholder funds	2,836.0	2,971.1	2,965.8	3,000.7	3,046.6							
Net debt	776.0	666.2	1,186.8	1,279.9	1,333.7							
Cashflow						06/14A	06/15A	06/16E	06/17E	06/18E		
EBIT	414.5	420.3	436.5	461.9	481.3							
Net interest	-84.7	-48.9	-47.7	-65.4	-72.6							
Depr & Amort	83.9	87.1	86.9	88.3	91.1							
Tax paid	-114.9	-84.0	-101.5	-120.9	-124.6							
Working capital	87.2	69.1	18.9	9.8	-50.0							
Other	-107.7	-3.8	-593.7	3.0	3.0							
Operating cashflow	278.4	439.8	-200.6	376.6	328.1							
Capex	-75.4	-64.4	-85.3	-86.6	-98.7							
Acquisitions & Invest	0.0	-37.5	0.0	-142.5	-105.0							
Asset sale proceeds	0.3	34.3	0.0	0.0	0.0							
Other	-0.6	0.0	0.0	0.0	0.0							
Investing cashflow	-75.7	-67.6	-85.3	-229.1	-203.7							
Dividends paid	-126.6	-121.0	-248.7	-256.3	-264.5							
Equity raised	0.0	2.4	13.9	15.7	26.5							
Net borrowings	-300.0	-520.0	524.8	50.0	120.0							
Other	540.5	0.0	0.0	0.0	0.0							
Financing cashflow	113.9	-638.6	290.0	-190.7	-118.1							
Total cashflow	316.6	-266.4	4.1	-43.1	6.3							
Adjustments	14.8	0.9	0.0	0.0	0.0							
Net Change in Cash	331.5	-265.5	4.1	-43.1	6.3							

Earnings						06/14A	06/15A	06/16E	06/17E	06/18E
Equiv. FPO (period avg.)	mn	1,417.3	1,447.1	1,464.2	1,464.9	1,470.7				
EPS (Normalised)	c	16.0	17.7	18.5	18.8	19.3				
EPS Growth	%		10.5	4.4	1.9	2.7				
Consensus EPS	c	16.1	17.8	19.0	20.0	20.8				
Consensus EBITDA	mn	499.9	509.1	527.9	551.0	574.7				
DPS	c	13.5	16.5	18.0	18.0	18.0				
Dividend Payout	%	84.4	93.3	97.5	95.7	93.2				
Free CFPS	c	14.3	25.9	-19.5	19.8	15.6				
Valuation										
P/E	x	23.4	21.2	20.3	19.9	19.4				
EV/EBIT	x	15.1	14.6	15.3	14.6	14.2				
EV/EBITDA	x	12.5	12.1	12.7	12.3	11.9				
Dividend Yield	%	3.6	4.4	4.8	4.8	4.8				
FCF Yield	%	3.8	6.9	-5.2	5.3	4.2				
Price to Book	x	1.9	1.8	1.8	1.8	1.8				
Returns										
Return on Equity	%	8.0	8.6	9.1	9.2	9.3				
Profit Margin	%	7.9	8.8	8.8	8.7	8.7				
Asset Turnover	x	0.5	0.5	0.6	0.6	0.6				
Equity Multiplier	x	2.0	1.9	1.9	1.9	1.9				
Return on Assets	%	4.0	4.6	4.9	4.9	4.9				
Return on Invested Cap.	%	8.0	8.1	7.3	7.5	7.6				
Gearing										
Net Debt to Equity	%	27.4	22.4	40.0	42.7	43.8				
Net Debt to EBITDA	%	1.6	1.3	2.3	2.3	2.3				
Int Cover (EBITDA/Net Int.)	x	5.7	9.4	11.0	8.4	7.9				
Int Cover (EBIT/Net Int.)	x	4.7	7.8	9.1	7.1	6.6				
Capex to Sales	%	2.6	2.2	2.8	2.7	3.0				
Capex to Depreciation	%	176.7	146.0	194.2	191.2	205.5				

MSCI IVA (ESG) Rating AA		Credit Suisse	
TP ESG Risk (%): 0		TP Risk Comment: No material ESG risks. TTS valuation already captures social concerns related to problem gambling. TTS has established responsible gambling codes of conduct for some of its lottery games. We see some, limited downside risk for the wagering division, which is currently investigating the deductibility of race information fees on interstate content with Queensland Racing.	
MSCI IVA Risk: Neutral		MSCI IVA Risk Comment: CS ESG risk assessment in line with MSCI rating	

Segmentals						
EBITDA						
Lotteries		296.6	313.6	340.4	356.0	369.2
	% chg	0.7%	5.8%	8.5%	4.6%	3.7%
	% sales	15.4%	15.9%	16.0%	16.2%	16.3%
Wagering		160.8	153.5	143.9	152.4	161.3
	% chg	-7.6%	-4.5%	-6.2%	5.9%	5.8%
	% sales	25.0%	24.3%	23.3%	23.8%	24.4%
Maxgaming		63.1	64.6	64.6	65.0	65.8
	% chg	0.1%	2.4%	0.0%	0.6%	1.1%
	% sales	55.2%	55.3%	54.6%	54.0%	54.0%
UK Gaming		13.6	16.4	20.6	20.9	21.6
	% chg	76.7%	20.3%	25.6%	1.4%	3.7%
	% sales	13.1%	14.1%	14.3%	14.3%	14.3%
Bytecraft		-0.4	2.8	5.8	5.8	6.0
	% chg	-63.9%	-85.5%	110.1%	0.0%	2.0%
	% sales	-0.3%	2.7%	5.6%	5.6%	5.6%
Corporate		-35.3	-43.5	-52.0	-50.0	-51.5
Total		498.4	507.4	523.4	550.2	572.3

Source: Company data, Credit Suisse estimates

Figure 2: Implied Multiples based on closing share price

Business Component	FY17 EBITDA A\$m	Multiple	Value A\$m	Per Share	Licence Period	Valuation Comment
NSW, QLD, SA Lottery	316	16.0x	5,041	\$3.44	Qld lottery license expires 2072. Qld Govt agreed not to issue another lottery license until after 2016 without compensating TTS. NSW Lottery expires 2050. SA Lotteries 40 years incl. Keno to 9 Dec. 2052.	TTS paid A\$530m for QLD Lottery in April 2007: 11.6x reported EBITDA, 6.2x EBITDA incl. Synergy. TTS paid A\$850m for NSW Lottery in March 2010 : 12.6x reported EBITDA, 7.0x EBITDA incl. Synergy. Tatts paid A\$427m for SA Lotteries management contract.
Vic Lottery	40	2.5x	100	\$0.07	Vic lottery license expire 2018.	Present value after tax of A\$30m-\$40m EBITDA for next 4 yrs. TTS paid A\$19mn in Dec 2007
Vic lottery option			100	\$0.07	Ten-year licence to be tendered by VIC Gov't soon.	Potential value created in successful Vic Lottery acquisition
Tatts Bet	152	7.5x	1,143	\$0.78	Qld wagering license, expire 30 June 2098. QLD retail wagering exclusivity to 30 June 2044. SA major betting operators license, exclusive 2016, expire 2100.	99 Year licence and flexible cost sharing with QLD racing industry. We are concerned about potential for rising costs, eroding market share and licence exclusivity payments.
Max gaming	65	7.0x	454	\$0.31	NSW licence extended to 2032 for \$209mn.	QLD is about 1/2 Maxgaming EBITDA and we value that at 7.0x EBITDA. Add to that the face value of the NSW licence payment
Talarius	21	7.0x	145	\$0.10		Transaction value on 3 Jan 08 A\$385m. Earnings depressed due to smoking bans and harm minimisation. Bottom of cycle multiple. TTS wrote Talarius down by A\$140m in FY10 accounts.
Bytecraft Corp	6 (50)	6.0x 7.0x	35 (350)	\$0.02 (\$0.24)		Maintains machines in QLD and VIC. VIC sales may be contested by competition when TTS loses machine ownership.
Franking Credits on future distributions			909	\$0.62		Not included in sum-of-the-parts valuation. Calculated at 50% per distributed credit for DCF purposes.
Entity value			6,668	\$4.55		
Net debt as at 30 June 2016			(1,187)	(\$0.81)		
Equity value			5,481	\$3.74		

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 02-Mar-2016)

Tatts Group (TTS.AX, A\$3.74, UNDERPERFORM, TP A\$3.3)

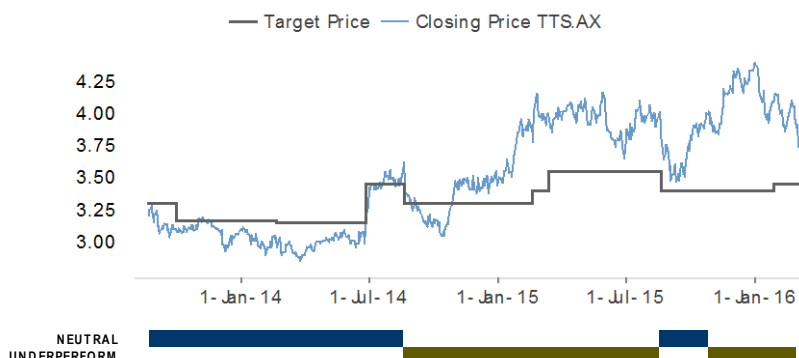
Disclosure Appendix

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3-Year Price and Rating History for Tatts Group (TTS.AX)

TTS.AX	Closing Price	Target Price	
Date	(A\$)	(A\$)	Rating
22-Aug-13	3.21	3.30	N
30-Sep-13	3.10	3.16	
20-Feb-14	2.96	3.15	
27-Jun-14	3.21	3.45	
21-Aug-14	3.41	3.30	U
18-Feb-15	3.87	3.40	
13-Mar-15	3.99	3.55	
20-Aug-15	3.81	3.40	N
30-Oct-15	3.96	3.40	U
27-Jan-16	4.09	3.45	



* Asterisk signifies initiation or assumption of coverage.

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Target Price and Rating

Valuation Methodology and Risks: (12 months) for Tatts Group (TTS.AX)

Method: Our Tatts Group (TTS.AX) target price of A\$3.30 approximates our discounted cashflow (DCF) of \$3.45 less next 12 months dividend of 17c. We assume a competitive advantage period of 20 years. Over this time frame, the company's growth rate is assumed to steadily diminish from 2% to zero and its return on new capital from 9.5% to weighted average cost of capital of 7.2%. Our UNDERPERFORM rating is based primarily on valuation with the current share price implying over 15x EBITDA for the lottery division. While the business is well managed and has reasonable growth prospects, we are not prepared to give Tatts a "utility-like" earnings multiple.

Risk: The key risks to our A\$3.30 target price and UNDERPERFORM rating for Tatts Group include increased government regulation (including factors such as wagering limits, gaming machines per venue, etc.) and market share losses in wagering.

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