Tabcorp Limited

November 2020

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Disclosure

Funds managed by Sandon Capital own securities in Tabcorp Ltd (Tabcorp or TAH).

Contents

Investment thesis

- A recent media report[1] has indicated that private equity firms are circling Tabcorp Ltd (TAH) and are interested in bidding for part or all of the company
- We view this as an unwelcome development given the longer-term improvements recently implemented at TAH are yet to be properly reflected in the company's share price
  - A Chairman and Managing Director who have overseen poor performance have both announced their imminent departure from the company
  - The balance sheet has been repaired following the recent equity raise and the sale of a non-core shareholding in Jumbo Interactive Ltd
  - The COVID-19 pandemic induced disruption to TAH's Wagering & Media (**Wagering**) and Gaming Services businesses appears to be rapidly receding given Australia's success in supressing coronavirus
  - The demonstration of the robustness of the Lotteries business model in the worst economic conditions since the Great Depression
  - An unsustainable dividend policy has been reset

1. www.theaustralian.com.au/business/companies/private-equity-and-matthew-tripp-circle-tabcorp-in-potential-breakup-deal-for-wagering-giant/news-story/6fe6732b69bf78e97971152b7290c334

Investment thesis

- In our opinion, the Company should optimise its structure by demerging its world class Lotteries & Keno (**Lotteries**) business. This would enable:
  - Separate Boards and management teams the ability to focus on their respective core businesses
  - Increased transparency allowing each business to be appropriately valued
  - The positioning of each business to pursue its own growth initiatives
  - Better allocation of capital, tailored to each company's needs and growth initiatives
  - Separate ASX listed entities that will appeal to investors with different investment strategies and preferences
- We believe a demerger is a superior long-term outcome for shareholders than the short-term sugar hit from any potential takeover
- We also believe a demerger can be achieved in a timely manner. This may address some shareholder frustrations, whilst also preserving opportunity for long-term holders. A demerger would also avoid regulatory and probity issues that would undoubtedly need to be addressed as part of a takeover or Scheme

Investment thesis

- On a sum-of-the-parts basis, we value TAH at $5.50-6.50 per share, 40-65% above the current share price. This does not include any premium for control. We do not believe this value will be realised whilst TAH remains in its current conglomerate structure

	Basis	Multiple Range		Value	
Lotteries & Keno	FY22 EBITDA multiple	18.0	20.0	10,900.7	12,111.9
Wagering & Media	FY22 EBITDA multiple	8.0	10.0	3,380.8	4,226.0
Gaming Services	FY22 EBITDA multiple	7.0	9.0	680.7	875.2
Corporate/Other	FY22 EBITDA multiple	7.0	9.0	(14.9)	(19.1)
Enterprise Value				**14,947.3**	**17,194**
Less: net debt				2,687.0	2,687.0
Equity Value				**12,260.3**	**14.507.0**
Shares on issue				2,217.1	2,217.1
Equity value per share				**$5.53**	**$6.54**
Market price at 24-Nov-20				**$3.96**	

Source: Sandon Capital analysis

Recent improvements yet to be reflected in share price

- When the TAH and TTS nil premium merger was announced in October 2016, the Boards of both companies heralded a number of benefits of bringing the two companies together. These included:
  - Creating a leading, diversified portfolio of gambling businesses
  - Greater scale and strong balance sheet position
  - Significant value creation for both sets of shareholders
- The passage of time has not been kind. Since the completion of the merger in December 2017, the logic for the merger has been stripped bare
- Whilst a *"leading, diversified portfolio of gambling businesses"* is a nice sounding theoretical construct, the reality has proven to be far different
- We believe that combining a Lotteries business that requires little capital and has a privileged competitive position with a Wagering business that is highly capital intensive and competitive, is akin to mixing oil and water and both businesses have suffered as a result

Recent improvements yet to be reflected in share price

- "*Greater scale*" may have resulted in higher compensation for management, however it has proven to be of no benefit to shareholders. In short, operational and financial performance of the combined entities has been poor
- A "*strong balance sheet position*" was never apparent as TAH failed to even commence the announced $500m share buyback post implementation of the merger. Subsequently the company has had raise equity to repair the balance sheet
- "*Significant value creation for both sets of shareholders*" has failed to materialise. As demonstrated by the material underperformance of the TAH share price, the contrary is true
- Shareholders of both TAH and TTS have been the biggest losers out of what has now been proven to be a merger based on hype, with little substance being delivered

Recent improvements yet to be reflected in share price

i. Imminent departure of Chairman and Managing Director

- After many years of poor operational and financial performance that have manifested themselves in an underperforming share price, events over the past 6 months point to a significantly improved longer term outlook for TAH and its shareholders
- On 23 July 2020, TAH announced that its Chairman, Paula Dwyer, will be retiring from the Board on 31 December 2020 and will be replaced by Steven Gregg. Concurrently, TAH announced that its Managing Director and CEO, David Attenborough, will retire in the first half of calendar year 2021
- We view both of these departures as much needed changes at the company. In our opinion, operational and financial performance has been poor for many years and accountability has been lacking

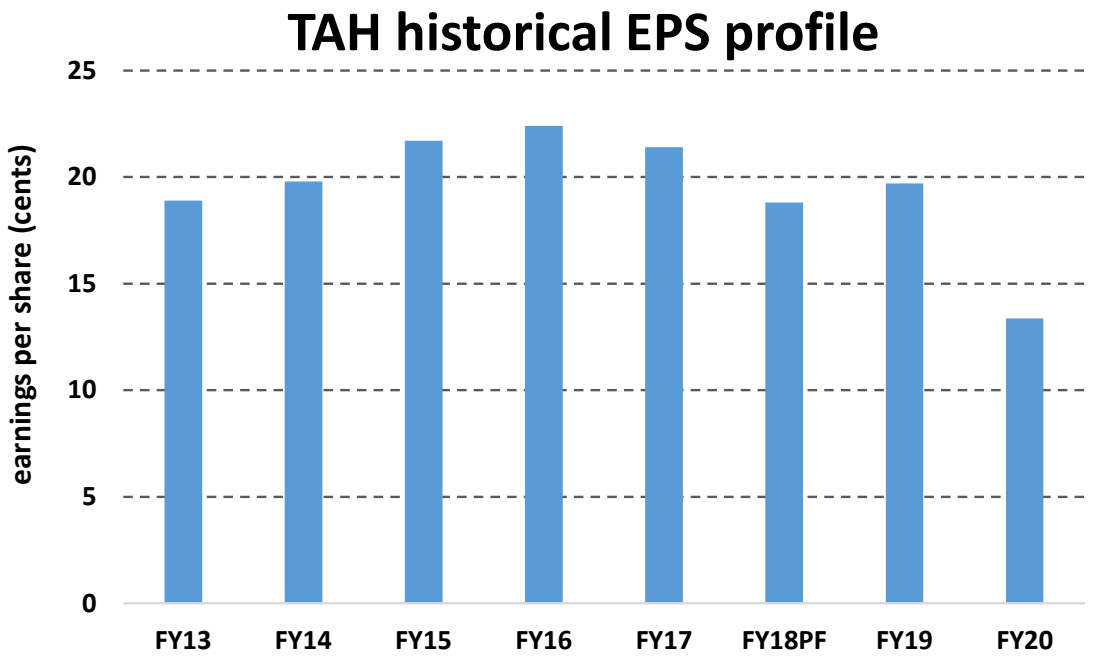
Recent improvements yet to be reflected in share price

- Poor operational and financial performance
  - In FY13, the first full year after the demerger of Echo Entertainment Group (now known as Star Entertainment Group) and the loss of the Victorian Tabaret gaming business[1], TAH reported earnings per share (EPS) of 18.9 cents
  - By FY20, TAH's EPS had declined by 29% to 13.4 cents. Whilst FY20 earnings were impacted by the COVID-19 pandemic, they had been on a downward trajectory since peaking at 22.4 cents in FY16
  - The FY20 results also included the contribution from the merger with Tatts Group Ltd (TTS), a merger that was heralded at the time of announcement as "*expected to be EPS accretive (before significant items) and value accretive for both Tabcorp and Tatts shareholders*" as a result of "*at least $130m per annum EBITDA synergies and business improvements*"
  - The subsequent operational and financial performance would suggest that the synergies have been illusory and the merger far from value creative

1. The Victorian Tabaret gaming business was in wind down in FY13, however was treated as a discontinued operation by TAH

Recent improvements yet to be reflected in share price

- Poor operational and financial performance
  - TAH earnings have been on a downward trajectory for many years prior to the COVID-19 pandemic. The merger with TTS may have delivered the Lotteries business cheaply to TAH shareholders, however the subsequent performance of the combined Group has been well short of expectations



Source: Tabcorp Ltd, Sandon Capital analysis

Recent improvements yet to be reflected in share price

- Poor operational and financial performance
  - The poor operational and financial performance of TAH has meant poor returns for shareholders
  - The TAH share price (including dividends) has meaningfully underperformed the S&P/ASX200 Accumulation Index over all short- and medium-term time periods until 31-Oct-2020

	1 year	2 years	3 years	5 years
TAH	-28.3%	-19.6%	-11.5%	-1.9%
ASX 200 Accum.	-8.2%	9.4%	12.2%	9.0%
Difference	**-20.1%**	**-29.0%**	**-23.7%**	**-10.9%**

Source: Bloomberg, Sandon Capital analysis

  - It is clear from the poor operational and financial performance at TAH and the resultant share price performance that change was desperately needed at Board and senior management level. We believe the new Chairman and yet to be appointed CEO have an opportunity to atone for the sins of the past

Recent improvements yet to be reflected in share price

ii. Balance sheet has been repaired

- Following the $600m entitlement issue in August, TAH's balance sheet is in a much-improved position. Concurrent with the entitlement issue, TAH announced a reduction in its target gearing range to 2.5-3.0x Gross Debt / EBITDA (from 3.0-3.5x previously)
- Shortly afterwards, TAH further buttressed its balance sheet by selling its stake in Jumbo Interactive Limited (JIN) for gross proceeds of ~$98m
- This selldown followed the execution of a 10-year reseller agreement with JIN that amended and extended the previous agreement. Importantly, the amended agreement included materially improved terms for TAH, with a service fee payable by JIN based on ticket subscription price. This service fee commences at 1.5% in FY21, rising to 4.65% from FY24
- The agreement also includes reseller termination rights should JIN be taken over by a third party, thereby protecting TAH's strategic position

Recent improvements yet to be reflected in share price

iii. Lotteries has demonstrated resilience

- As previous shareholders of TTS prior to the merger with TAH, we highlighted the infrastructure like qualities of its Lotteries business
- The resilience and durability of Lotteries' business model has been reinforced during the COVID-19 pandemic
- According to TAH's FY20 result presentation, like-for-like sales for the Lotteries business were up c.15-30% during COVID-19 restrictions
- This was in stark contrast to many traditional infrastructure assets such as toll roads and airports which were virtually shutdown at the height of the pandemic restrictions and continue to see negative impacts on their revenues today
- The 10th October 2020 refresh of Saturday Lotto, resulting in an increased prize pool and larger one-off jackpots, has shown early signs of resurrecting growth in this product. We don't believe the market has fully appreciated the positive impact this refresh will have

Recent improvements yet to be reflected in share price

iv. COVID-19 impact appears to be rapidly receding

- TAH's Wagering & Media, Keno and Gaming Services businesses were heavily impacted by COVID-19 pandemic lockdown measures in 2HFY20
- Licenced venues (hotels and clubs), TAB agencies and on-course outlets were all negatively impacted by closures or social distancing requirements
- Whilst domestic horse racing was allowed to continue, COVID-19 measures saw the postponement or cancellation of sports and international horse racing
- This impact continued to be felt in 1HFY21, particularly in Victoria, a key market for TAH, as a result of the shutdowns associated with the second wave of COVID-19
- However, with local transmission of COVID-19 currently non-existent around Australia, and retail venues now reopened, we expect a solid rebound in the COVID-19 impacted businesses

Recent improvements yet to be reflected in share price

v. Unsustainable dividend policy has been reset

- As a result of its highly leveraged balance sheet and the negative earnings impact from COVID-19, TAH was forced to approach its banking syndicate for covenant relief in 2HFY20
- As part of securing waivers, TAH resolved not to pay a final dividend for FY20. At the time, we viewed this as a circuit breaker to reset a dividend policy that was a millstone around the Company's neck
- When announcing its entitlement issue in August 2020, TAH disclosed that it was reducing its *"target dividend payout ratio to 70-80% of NPAT (before significant items) on the resumption of dividends"*
- This comes after many years of "dividend policy creep" whereby TAH's dividend payout ratio was slowly increased to unsustainable levels to placate yield hungry investors and draw attention away from operating issues, particularly in the Wagering business

Recent improvements yet to be reflected in share price

- In our opinion, the unsustainable dividend policy has been detrimental to the operating performance of the Company. We believe it has led to underinvestment in TAH's Wagering business, resulting in an uncompetitive product and market share losses
- As a result of the improvements that have been seen at TAH in the past 6 months, we do not believe it is the appropriate time to engage with an opportunistic private equity predator
- In fact, we believe now is the opportune time to unwind a failed experiment (the TAH / TTS merger) and deliver an outcome that is truly value creative for shareholders; a demerger of the world class Lotteries business such that a standalone entity can be appropriately valued by the market

Lotteries should be demerged

i. Separate Boards and management focused on their respective core businesses

- Whilst there are a number of successful gambling/gaming companies globally, we cannot identify one that is a sprawling conglomerate like TAH. We believe those that have been successful have focused on their core competencies and have dominated their key market
- By demerging the Lotteries business with an independent Board of directors and management team, we believe it will be better able to focus on its core business and implement a focused strategy
- This would allow Lotteries to flourish as an independent company, without the distractions that have beset the Wagering business
- Similarly, a standalone Wagering business could focus exclusively on addressing its problems, without relying on the safety net of the strong and dependable cash flows from the Lotteries business

Lotteries should be demerged

ii. Increased transparency allowing each business to be appropriately valued

- In the ~14 years that Lotteries has been part of a conglomerate structure, an underperforming Wagering business has been the lowest common denominator that has driven the performance of the stock
- Whilst it remains housed within a gambling conglomerate, we believe that the market will continue to misprice the Lotteries business
- In our opinion, a demerger will serve to highlight the differing operating and strategic characteristics, financial profiles and risks of the Lotteries and Wagering businesses. Once separated and trading independently on ASX, investors will be able to value each business appropriately
- As discussed in the following pages, we believe the Lotteries business has attributes that are very similar to infrastructure assets and should be valued accordingly

Lotteries should be demerged

- Lottery concessions in Australia are state-based monopolies, very similar in structure to infrastructure concessions
- They have significant barriers to entry and provide their owners with a dominant market position
- 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. Furthermore, ongoing investment required to maintain lottery operations is low
- An advantage of lottery concessions is that they are significantly less capital intensive to operate than traditional infrastructure concessions such as toll roads, ports and airports
- Lotteries are also much more resilient to economic cycles and have a more stable earnings profile. Recent performance has proved this beyond doubt

Lotteries should be demerged

- Historically, traditional infrastructure assets have had little sensitivity to economic downturns. The Lotteries business has proven itself to be significantly more durable than traditional infrastructure assets during the severe economic contraction arising from the COVID-19 pandemic

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

Source: Sandon Capital analysis

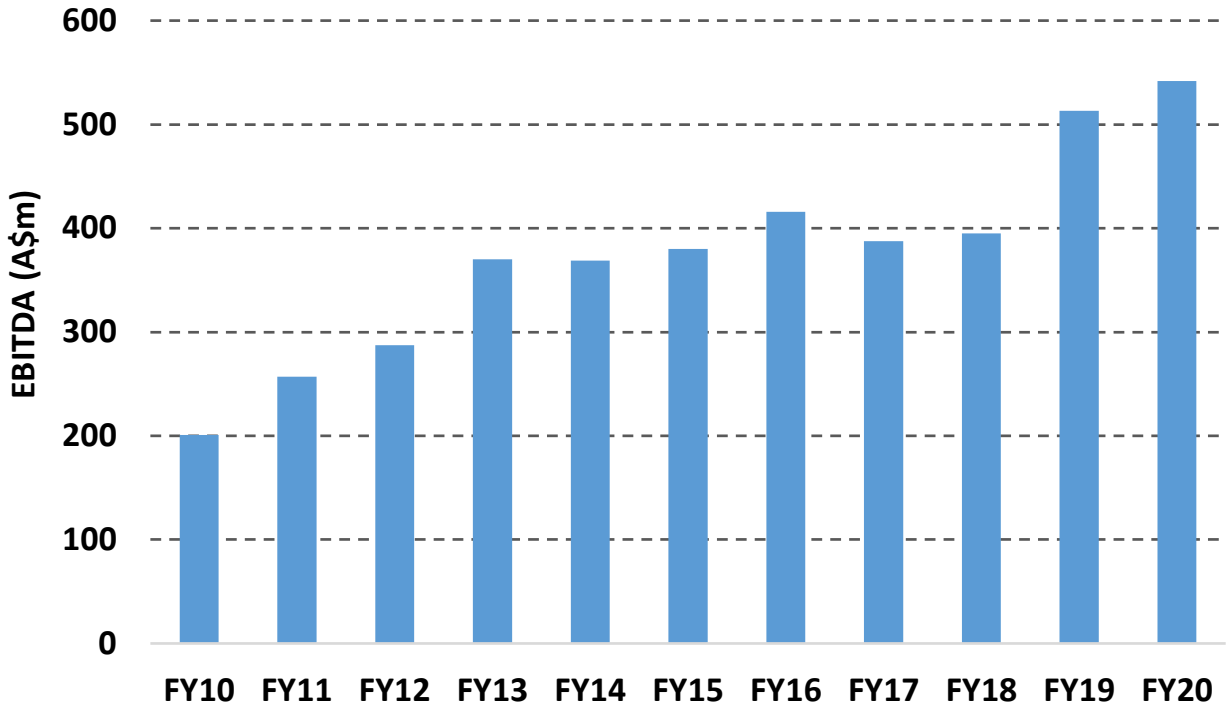
Lotteries should be demerged

iii. Each business to pursue its own growth initiatives

- In our opinion, TAH's Lotteries business has proven itself to be impervious to economic cycles and has generated sustainable long-term earnings growth with minimal ongoing capital expenditure
- As a business that produces rather than consumes working capital, its organic growth has been self funded
- Since FY10, the combined TAH and TTS Lotteries businesses have grown EBITDA from $201m to $542m, a compound annual growth rate in excess of 10%
- Most of this growth has been organic, augmented by the acquisition of NSW Lotteries in April 2010 and the acquisition of the operating rights for South Australia's lottery and keno service in December 2012
- Importantly, the capital light nature of the Lotteries business means that very little cash has been outlaid to achieve the organic growth

Lotteries should be demerged

- Earnings from the combined TAH and TTS Lotteries businesses have grown strongly over the past decade



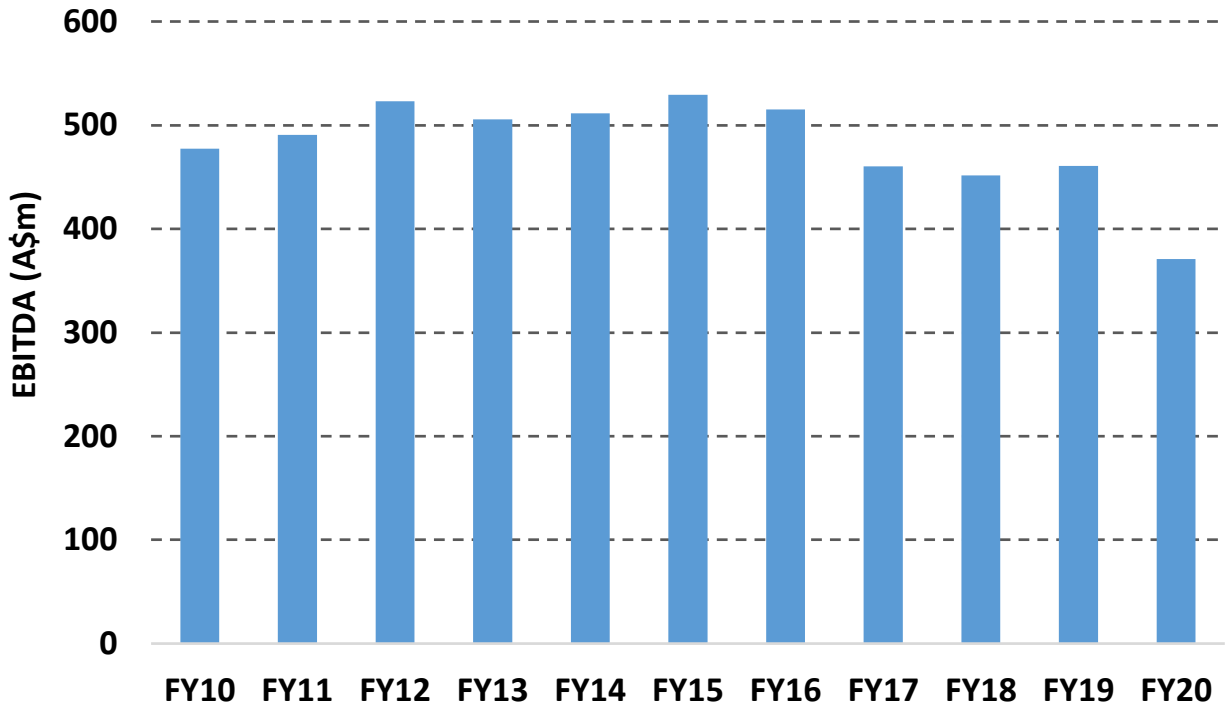
Source: Tabcorp Ltd, Tatts Group Ltd, Sandon Capital analysis

Lotteries should be demerged

- In contrast to the strong earnings growth seen in Lotteries, the combined Wagering businesses of TAH & TTS have seen earnings go backwards over the past decade
- In FY10, the TAH and TTS Wagering businesses reported combined EBITDA of $478m. A decade later, the combined businesses reported FY20 EBITDA of $371m, a decline of 22%
- Whilst the FY20 figure included the negative earnings impact of the COVID-19 pandemic, it does include most of the cost synergies (>$80m) that have resulted from the merger of TAH & TTS
- The declining earnings profile would suggest that these supposed synergies are illusory and have been competed away
- Furthermore, given the highly competitive nature of the Wagering industry, a significant amount of capital expenditure is required simply to keep up with other players

Lotteries should be demerged

- Earnings from the combined TAH and TTS Wagering businesses have gone backwards over the past decade



Source: Tabcorp Ltd, Tatts Group Ltd, Sandon Capital analysis

Lotteries should be demerged

- We believe there are a number of opportunities for the Lotteries business to further grow its earnings:
  - The purchase of the New South Wales (NSW) Lotteries tax stream should the NSW Government decide to sell it[1]
  - Increased online penetration
  - A game refresh and price increase for Oz Lotto
  - Examine whether a regional lottery bloc is feasible. For example, with New Zealand and/or Singapore
- Conversely, the focus for the Wagering business should be on a turnaround from the underperformance seen over the past 5+ years. We believe this is best done with a dedicated Board and management team, experienced in the Wagering industry as well as corporate turnarounds

1. https://www.treasury.nsw.gov.au/sites/default/files/2020-11/Media%20Release%20-%20NSW%20Treasury%20-%20Scoping%20study%20into%20lotteries%20duty%20anounced_0.pdf

Lotteries should be demerged

iv. Better allocation of capital, tailored to needs and growth opportunities

- The capital requirements of the Lotteries and Wagering businesses are diametrically opposed
- Lotteries is a capital light business that self funds its own growth. Whilst TTS did not previously disclose the annual capital expenditure for its Lotteries segment, improved disclosure by TAH has shown that the annual capital expenditure requirement for Lotteries equates to ~1% of net sales revenue
- This is consistent with the capital expenditure levels reported by NSW Lotteries, Golden Casket and SA Lotteries prior to their acquisition by TTS
- Consequently, its business model can manage higher leverage and its strong cash generating capabilities are better suited to a higher dividend payout ratio
- In contrast, Wagering is in a fiercely contested industry that will require significant capital investment, both to remain competitive and also to orchestrate the turnaround of an underperforming business

Lotteries should be demerged

- Prior to the acquisition of TTS Wagering business, TAH was spending 3.5 – 4.5% of its Wagering net revenues on capital expenditure. That figure has risen to 6.5 – 7.0% since the acquisition of TTS Wagering
- The underperformance of the combined TAH and TTS Wagering business relative to their online corporate bookmaker peers would suggest that both TTS and TAH underinvested in their Wagering businesses despite the large capital outlays. The world's largest online corporate bookmaker, Flutter Entertainment plc, has consistently spent 5.5 – 8.0% of its net revenues on capital expenditure
- Hence, Wagering is a business that should carry a minimal amount of debt and retain a higher proportion of earnings to buttress its balance sheet
- Following a demerger, Lotteries and Wagering will be able to adopt independent capital structures and financial policies appropriate for their respective operational requirements and strategic objectives. That is not currently possible under TAH's current conglomerate structure

Lotteries should be demerged

v. Separate entities that will appeal to investors with different investment preferences

- The operating characteristics and financial policies of Lotteries and Wagering differ significantly and will likely appeal to different types of investors. Their combination within a single Group does not provide choice for investors who seek an investment in one of the businesses, but not the other
- A demerger will increase the options available to investors by creating two distinct entities with vastly different characteristics:
  - Shares in Lotteries will provide exposure to a capital light growing business with the potential for inorganic opportunities to further supplement growth
  - Shares in Wagering (inc. Gaming Services) will provide exposure to a capital-intensive business with competitive industry dynamics, with the potential and opportunity for significant improvement/turnaround

Lotteries should be demerged

- As outlined, we believe the obvious solution to the current situation of discordant businesses being housed under the same corporate roof is for TAH to demerge its strongly performing Lotteries business from its underperforming Wagering business
- This will unlock the inherent value in the Lotteries business and allow Wagering to fix its problems without distraction
- Furthermore, it will allow streamlined businesses to adopt appropriate capital structures and financial policies whilst remaining focused on their respective growth opportunities
- Finally, it will allow investors to choose which business they wish to have exposure to. This choice is unavailable today due to the conglomerate structure of TAH
- We believe this is a superior path to follow than succumbing to the short-term sugar hit of a potential takeover by private equity

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 and is a non executive director of Future Generation Investment Company Ltd.

Campbell Morgan – Analyst

Campbell joined Sandon in 2014 and has almost 20 years of experience in both Australian and International financial markets. Prior to joining Sandon, Campbell managed a Global Materials portfolio for Millennium Management, a New York based hedge fund with ~US$40bn under management. Preceding this, he was a Senior Analyst for a Global Industrials portfolio at Citadel Investment Group, a >US$30bn Chicago based hedge fund. Campbell started his career in Australia, working in the Institutional 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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