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Gaming: Maintaining a Winning Edge

Our weekly view on Australian equities.

24 May 2023

Gaming Resilience

Gaming revenues have shown resilience over time, as the industry tends to be relatively unaffected by economic downturns.

Gaming stocks offer the Focus Portfolio resilient growth at a point of the cycle where we believe this is key to outperformance as the broader market is likely to experience earnings downgrades.

Gaming revenues have historically exhibited relatively inelastic, if not countercyclical, demand characteristics. This resilience can be attributed to the fact that people may continue participating in gambling activities, seeking entertainment and the possibility of winning despite financial constraints. Even during economic slowdowns/ downturns, consumers still tend to allocate a portion of their discretionary income towards gambling activities.

Lotteries: Prizewinning Resilience

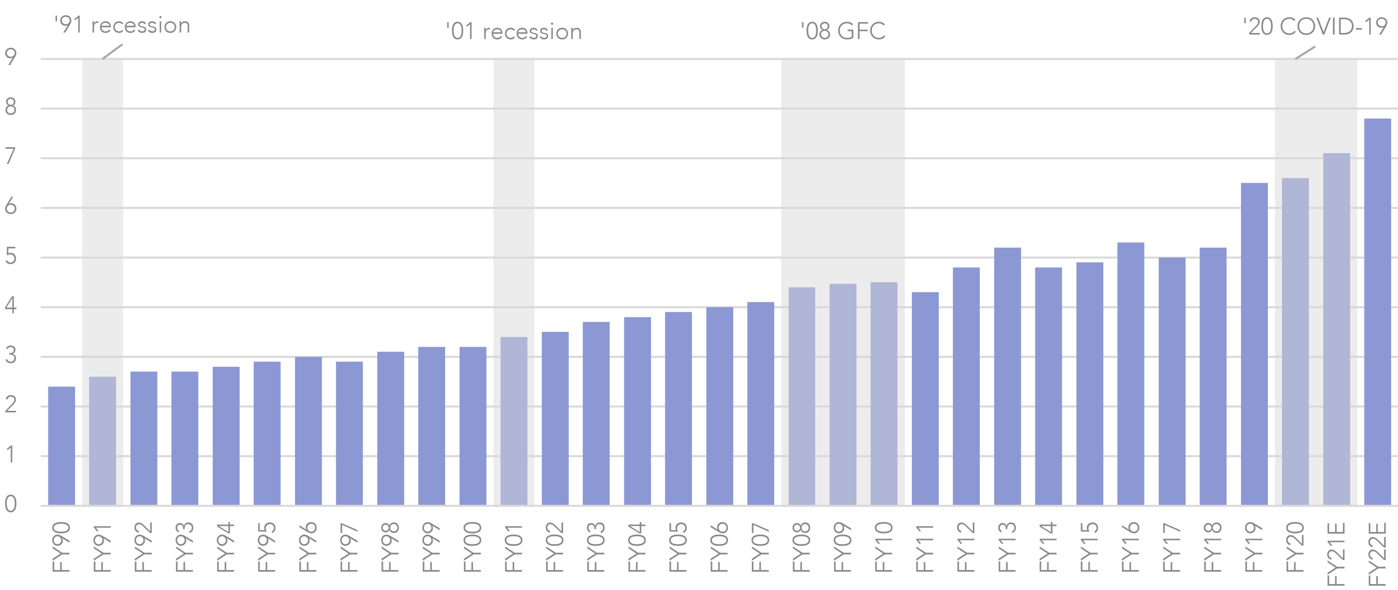
Lottery consumption has remained relatively consistent over time and resilient during downturns.

Despite being a discretionary purchase, lotteries have exhibited annuity-like characteristics, with the key drivers of growth being stable factors such as population growth. TLC has achieved consistent growth in revenue and earnings throughout the economic cycle (including COVID-19). This is mainly driven by base games, which provide a predictable revenue stream from loyal customers. Base games account for 56% of lottery revenue.

Even during past global recessions (most recently in 2020 due to the pandemic) lottery consumption has consistently increased partly due to relatively low ticket prices (vs other bigger ticket expenditure items). Because it is such an inexpensive product, it is probably not one of the first things cut from the regular monthly budget. Additionally, consumers with fewer discretionary dollars left at the end of their budget probably look for cheaper forms of entertainment than usual.

Economic downturns may prompt people to justify small-stakes gambling even as they cut back on non-essential goods and services. A lottery win (while unlikely) has the potential to change someone's life, at a reasonably low cost.

Figure 1: Australian lottery sales (in A$bn) have increased during downturns



Source: Australian Gambling Statistics, Tabcorp/TLC financial reports. *FY90 – FY19; excludes commission, June year end; FY21E & FY22E: estimated based on Tabcorp/TLC revenue growth. Wilsons.

Gaming: Not Relying on Luck

Gaming has demonstrated resilience in periods of slow economic growth. For example, studies conducted[1] during economic downturns have shown that despite the overall decline in consumer spending, gaming revenue has remained relatively stable or has experienced a modest decline compared to other sectors.

[1] https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3501160/

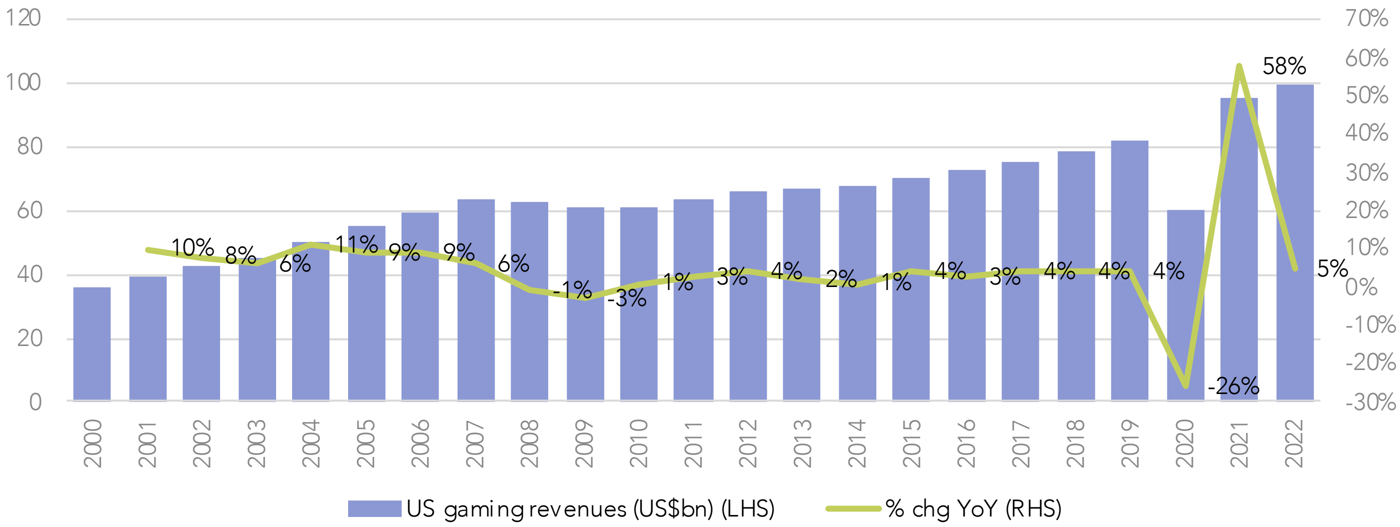
From 2000 to 2022, US casino gaming revenues grew a CAGR of 4.8%. There were only 3 years in which revenues declined: 2020 (COVID) and 2008 and 2009 (GFC), but they were just 1% and 3%, respectively. To put this in perspective, US retail trade fell 10% in 2009.

While 2020 was a volatile period, this was due to mobility restrictions rather than an economic shock.

Our current expectations are not for a sharp decline in gaming demand in the next 12 months.

Aristocrat Leisure (ALL) and the Lotteries Corporation (TLC) are our key holdings in the gaming sector. While we believe these stocks can provide the portfolio with resilience over the next 12 months, these stocks also have strong earnings growth potential over the medium and long-term.

Figure 2: US gaming has also been resilient over the past 20 years



Source: UNLV Center for Gaming Research, National Indian Gaming Commission, American Gaming Association.

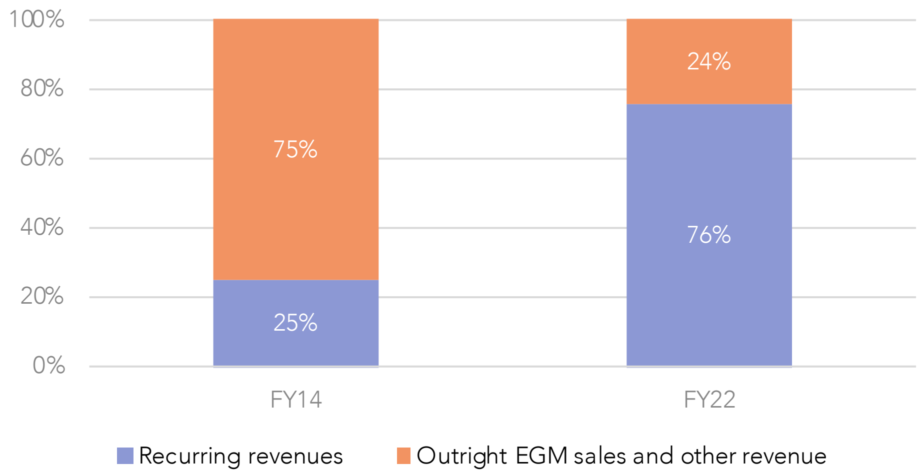
Aristocrat (ALL): The Next Leg of Growth

Aristocrat Leisure is a core holding of the Focus Portfolio (3% weight). ALL is a global gaming technology provider best known for its core electronic gaming machine (EGM) business, Aristocrat Gaming, which is a leader in the North American and Australian / New Zealand markets, although the company has also made significant strides over the past decade into digital/mobile gaming, via Pixel United.

ALL has transformed itself over the last decade to become a predominately recurring revenue style business. Previously, the business generated most of its earnings from 'one-off' outright sales of EGMs to casinos and other licensed venues. Nowadays, the majority of ALL's revenues are recurring in nature. This has been driven strong growth in its 'gaming operations', where EGM's are leased to venues for a fee-per-day, as well by growth in Pixel United.

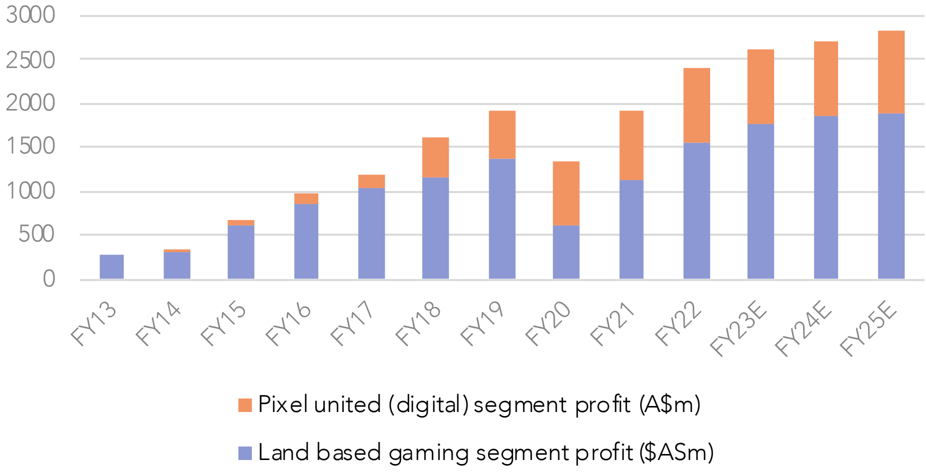
Unlike Aristocrat Gaming, Pixel United's games are completely 'free-to-play' and are monetised largely through in-app purchases (rather than wagering) across a suite of categories including social casino (e.g. Cashman Casino), casual (e.g. Gummy Drop), and RPG, Strategy & Action games (e.g. RAID: Shadow Legends). Pixel United has taken even more cyclicality out of ALL's earnings.

Figure 3: ALL has transformed its business to generate more revenue from recurring sources



Source: Refinitiv, Wilsons.

Figure 4: Pixel United has provided another avenue for growth over the past decade; we expect Anaxi to provide the next leg of growth



Source: Refinitiv, Wilsons.

After a strong decade of digital growth from Pixel United, we expect the next leg of ALL's earnings growth over the coming decade to be driven by ALL's recently established online Real Money Gaming (RMG) business, Anaxi.

Anaxi: Building a Stake in iGaming

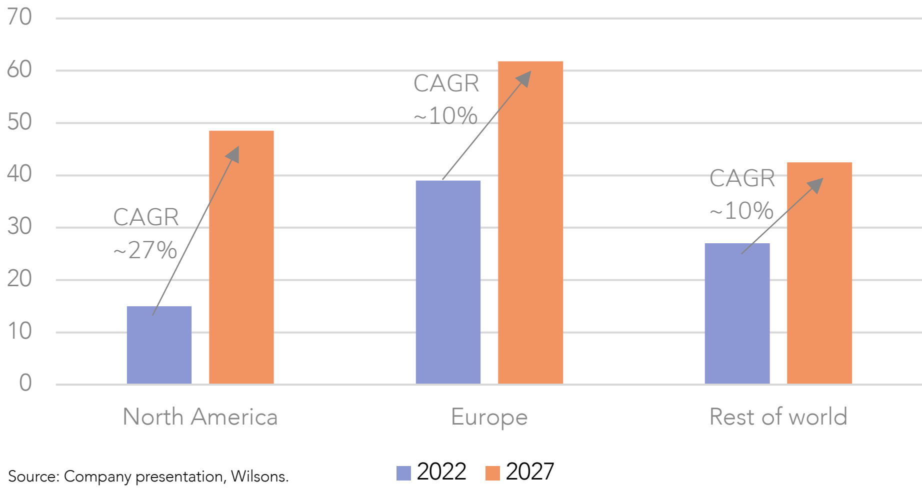
The recently announced acquisition of Nasdaq-listed NeoGames for $1.8bn (if successful) will be ALL's most significant stride into the online RMG market, which involves wagering with real money online (as opposed to social casino which don't offer users the potential for financial winnings) across a variety of game-types including casino-style games, lotteries and online sports betting (OSB).

The NeoGames acquisition was strategically important for ALL's online RMG ambitions, as it will equip the business with the technology stack (most crucially the Player Account Management (PAM) software) required to distribute its premium content to iGaming providers via a fully integrated offering. Management had previously flagged the strategic importance of owning a PAM, and that it would be a 'buy' not 'build' part of its iGaming strategy.

Online RMG has a large and rapidly growing total addressable market (TAM), particularly in the burgeoning US market where legislative changes in recent years have allowed OSB and iGaming to be legalized and regulated at the state level. The global online RMG TAM is estimated at US$81bn in 2022, including a North American TAM of US$15bn, which is expected to grow a CAGR of ~27% over the next 5 years.

In the key US market, iGaming is currently only legal and regulated in 7 out of 50 US states (some of which are still relatively immature), leaving a large runway for growth in the coming years as more jurisdictions move to regulate the

Figure 5: The growth potential for iGaming is substantial (total addressable market of online real money gaming (RMG) in US$bn)



Source: Company presentation, Wilsons.

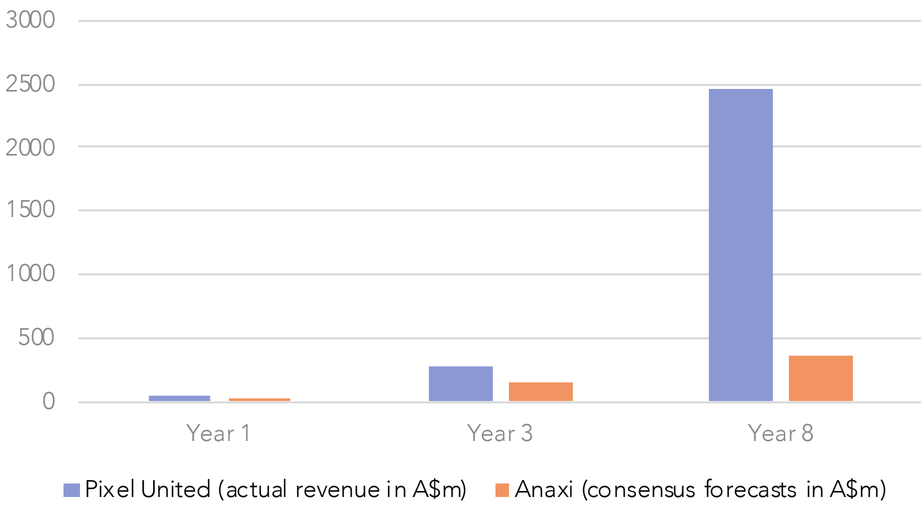
industry (incentivized by the significant tax revenues on offer) and as gaming online continues to gain popularity. We think iGaming could offer very attractive unit economics at scale with iGaming products having a less COGS compared to ALL's other segments (e.g. EGM physical hardware costs and mobile gaming platform costs).

We are confident that ALL has the potential to participate in this industry growth and become a leading platform for the global online RMG industry, presenting meaningful upside to its long-term earnings, given:

- Ability to leverage existing IP – In our view, content quality and popularity will ultimately be the key determinant of success for iGaming product launches (as it is with EGMs). In this context, ALL is well placed to 'hit the ground running' by repurposing its popular land-based EGM and social casino titles into iGaming offerings. We note ALL has spent significantly more than its competitors on R&D in recent years, giving the business a head start in iGaming vs both land-based competitors and newer online gaming players. Moreover, ALL's diversification across land-based gaming, mobile games (particularly social casino), and online RMG could also underpin industry leading profitability for Anaxi at scale, as the segment will have the ability to tap into ALL's existing R&D program (which is supported to a degree by the other segments). Having what is effectively a single R&D program leveraged across 3 divisions should drive incremental margin benefits for the overall ALL business over time.

- **iGaming is a highly fragmented market** – The relatively immature iGaming market is highly fragmented with the #1 player achieving just <5% market share at present. This presents a significant opportunity for ALL to benefit from its strong balance sheet and existing relationships with customers (e.g. casinos and online gaming operators) to take meaningful market share over the medium-term.
- **Strong track record of pivoting into new adjacencies** – ALL's success in scaling Pixel United to become a top 5 mobile games producer with US$1.8bn of revenue in FY22 after just ~8 years is a noteworthy case study / precedent that highlights management's ability to successfully expand into new verticals.
- **Consensus forecasts underappreciate the size of the opportunity** – We expect Anaxi to drive meaningful earnings (and valuation) upgrades for ALL over the next 5-10 years as consensus forecasts appear highly conservative for this segment, likely reflecting a cautious approach from the sell-side given the relative immaturity of the online RMG sector which at present has only an incipient earnings base. Current consensus expectations are for Anaxi's revenues to peak at ~$350m in FY30 (after ~8 financial years in operation). By way of comparison, over the same time frame (i.e. in the 7 years between FY14-FY20), ALL scaled the revenues of Pixel United from zero to $2.4bn within a similarly sized global market. Therefore, if ALL executes successfully with Anaxi in line with our expectations, we see the scope for significant earnings upgrades in the coming years.

Figure 6: After 8 years, Pixel United became a substantial segment for ALL; we think the same can happen for Anaxi (this is not reflected in consensus)



*Year 8 is FY30 for Anaxi and FY22 for Pixel. Source: Visible Alpha, Wilsons.

The Lotteries Corp (TLC): Digital Expansion, Margin Expansion

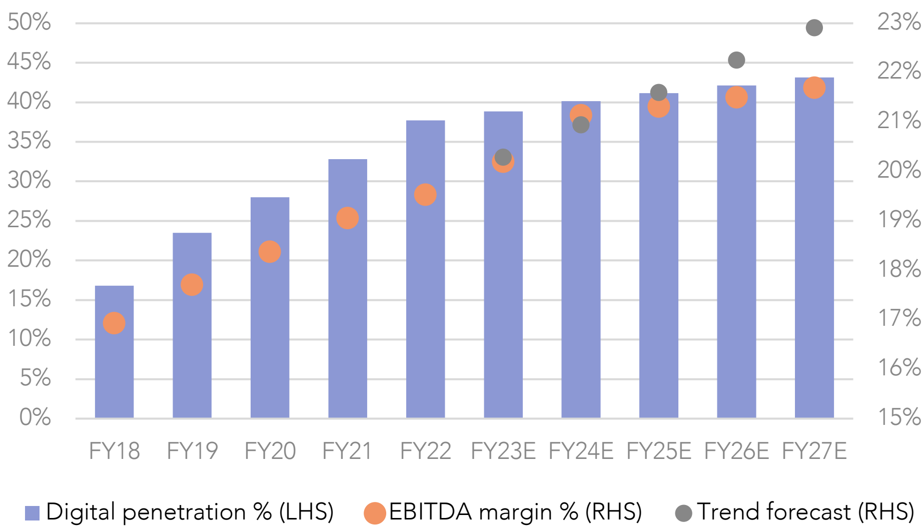
While a resilient business (proven in the COVID pandemic), TLC also provides an avenue for earnings growth which we still deem to be underappreciated by the market – digital expansion.

The digital share of turnover is increasing in the lotteries business. Digital sales of lottery products offer margin upside compared with in-store sales. With only ~38% of lottery sales currently online, we there is a sizeable opportunity for further digital penetration, which should be earnings accretive given the digital sales are ~3x higher margin than the retail channel. Therefore, this segment should still have robust earnings growth over the next few years as the transition continues towards digital sales.

We see potential earnings growth for this business in the low double digits over the medium-term.

TLC has a monopoly on Australian lotteries (excluding WA), exhibits strong and resilient free cash flow generation, and has low capital intensity. TLC is capital light. The lotteries business is expected to have a strong operating cash flow conversion ratio of above 100%. High levels of cash generation should mean cash can be reinvested into the business or passed back to shareholders.

Figure 7: TLC digital and EBITDA expansion looks too conservative in consensus on the previous trend



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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Wilsons contact

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

greg.burke@wilsonsadvisory.com.au | +61 2 8247 3118

www.wilsonsadvisory.com.au