



# Play the growth game

Roger Montgomery looks at an online lottery ticket seller

**E**THICAL INVESTING IS A VERY personal matter. If ethics have formed part of an investor's framework, then each has their own line in the sand. Some investors won't invest in weapons or alcohol producers or distributors. Others have trouble with cigarettes. Then, of course, there's the issue of listed companies having some, rather than total, exposure to ethically debatable ventures. And, finally, there are the companies (banks, for example) that have fund management arms that invest in companies that might not pass everyone's ethical screens. Where you draw the line is entirely up to you.

Founded in Brisbane by Mike Veverka, Jumbo Interactive (ASX code JIN, Skafo Quality Score B1) is a Brisbane-based online business selling lottery tickets via its [www.ozlotteries.com](http://www.ozlotteries.com) website. Jumbo sells lottery tickets nationally, except in Queensland, through agreements with three states (NSW, Victoria and SA).

And it might not pass your ethical filters. In the US, lotteries were outlawed in the 19th century and did not become legal again until the 1960s.

A 2008 study from the *Journal of Risk and Uncertainty* highlights that lotteries appeal to people earning lower incomes and they spend a disproportionate amount of money on the lottery compared with people on higher incomes.

And Yale University's Emily Haisley found poor people play the lottery even more when times are tough.

We're struggling with these issues as some of our own team buy Lotto tickets and, somewhat irrationally, even more participate when there's a jackpot. But for those that don't have any issues with the regressive nature of lotteries, Jumbo may be a name to investigate further.

Commencing with sales in 2000, Jumbo is effectively a reseller for state governments, typically under five-year agreements (a five-year agreement with NSW lotteries, now owned by Tatts Group,

expires in December 2013 and a reseller agreement with Tatts for Victoria lotteries expires in July of the same year).

Currently just Tatts and Jumbo enjoy most of the benefits of the resultant duopoly-like conditions, which amount to some pricing power and stability.

Lotteries in Australia are a mature market, so Jumbo's growth is a function of the online migration story. While online ticket sales penetration amounts to less than 8% of annual sales of \$3.6 billion (equivalent to \$205 a year for adult Australians), Tatts Group has 60% market share and Jumbo about 35%, with Intralot the remainder. If the barriers to entry through regulation are high enough to prevent new entrants, the low online ticket sales penetration is a significant growth opportunity for Jumbo.

This was best highlighted by the recent 58% net profit before tax growth delivered in the first-half result, with revenue and

earnings before interest, taxes, depreciation, and amortisation (EBITDA) growth of 32% and 56% respectively. This was on top of revenue growth of 15% for the year ending June 30, 2011.

Each \$1 lottery ticket sold by Jumbo is effectively purchased for 91c and sold at \$1.10, generating a gross margin of almost 21%. And with software, website and administration expenses largely fixed (don't believe it if Jumbo expands to the US), the additional gross margin drops straight to the bottom line.

The company claims it has 50,000 to 100,000 regular customers, spending on average about \$20 a week. But 100,000 spending \$20 a week, would amount to revenue of \$104 million – and in 2011 it was just \$75 million. So: 1) the other 18,000 claimed regular customers spent nothing, and there were few other customers; or 2) the number of regular players is closer to 70,000 than 100,000; or 3) you can expect substantial revenue growth in 2012.

According to Skafo, the shares are trading at a meaningful discount to estimated intrinsic value. Assuming Jumbo earns \$10 million in 2014, doesn't issue additional shares and the market is still willing to pay 10x forecast earnings, the shares could trade at \$2.16 in 2013, producing a simple return of 50% in 13 months.

The opportunities for further profit growth and share price increases can be attributed to expansion (state lottery licence wins) in the US and further profit upgrades; the longer-term risks are state governments not renewing domestic licences and the possibility of Tatts reinvigorating its online competition. The latter should not be underestimated and anyone believing Tatts won't want to upset its newsagency distribution model should look at what happened to CD music stores. A final point to watch, and something I have discussed previously, is to keep an eye on directors selling shares.

*The author may own shares in JIN. Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book Value. Able, see [www.rogermontgomery.com](http://www.rogermontgomery.com).*

