

# ValueLine: Tatts Group



By Roger Montgomery

**PORTFOLIO POINT:** Tatts Group's purchase of NSW Lotteries could reduce its intrinsic value. A lottery ticket might be a better investment.

When an investment goes bad, sometimes shareholders are urged to "put in the bottom drawer and forget about it": to cross your fingers, close your eyes and hope that maybe one day it will come good. This is tantamount to bad advice.

Shares represent stakes in and claims on the long-term cash flows of operating businesses and because companies are dynamic, rarely is there an opportunity to simply buy a stock and stick one's head in the sand.

The recent purchase of an exclusive 40-year licence to operate the NSW Lotteries by the Tatts Group (TTS) is a case in point. The \$850 million purchase price, on top of the annual \$300 million in duties from the sale of NSW Lottery products and the return of \$160 million in cash on the balance sheet, surprised analysts who had been anticipating a winning bid of \$600–650 million.

The deal also surprised competing bidders who have argued that the sale was illegal because of the inclusion of provisions that to keep all unclaimed prizemoney over the life of the 40 year contract. As an investor, I am only interested in whether the purchase affects the value of the company to such an extent that it either materially improves or declines.

The dynamic nature of business and the institutional imperative to grow means that companies in your portfolio are always changing, not only in their nature, characteristics and management but also in their prospects, competitive position and most importantly, intrinsic value.

But in this case something doesn't seem to add up. While my own back-of-the-envelope estimate suggests the acquisition was indeed a good deal for the NSW government, the acquisition may have had more to do with Tatts Group thwarting the aspirations of a rival company than improving its own key performance indicators such as returns on equity.

NSW Lotteries' revenue has grown every year since 2000, when it raked in \$945.9 million, to 2008 when it was reported that it had generated revenue of \$1.21 billion. Tatts Group expects integration costs of \$14 million, which will be amortised over three years, and for NSW Lotteries to generate EBITDA of \$120 million by 2014.

But EBITDA is not NPAT and NPAT is the ultimate profit that is distributable to owners is after the interest, tax and even depreciation has been paid (if you believe that depreciation is a reasonable estimate of the maintenance capital expenditure).

If the transaction is funded with 80% debt and 20% cash, then in 2014, NPAT may be about \$48 million, which is less than the reported \$56 million in profits the NSW government earned last year. The purchase price is therefore 18 times 2014 profits after tax.

## The ValueLine portfolio, as at March 30, 2010

Company	Buy price	Price today	Est value**	Margin of safety	Shares bought	Invested	Capital value	Divs rec	Total return	Total return
JB Hi-Fi	14.8	20.3	19.65	-3.3%	845	\$12,500	\$17,145	0.62	\$5,169	41.35%
Cochlear	56.36	72.84	56.3	-29.4%	102	\$5,744	\$7,424	1.9	\$1,873	32.61%
CSL	31.81	36.43	32.87	-10.8%	163	\$5,197	\$5,952	0.75	\$877	16.88%
Woolworths	26.16	28	26.85	-4.3%	206	\$5,377	\$5,756	1.09	\$602	11.20%
Reece	17.8	25.75	17.78	-44.8%	236	\$4,209	\$6,089	0.53	\$2,005	47.64%
Platinum Asset Mgt	4.06	5.2	4.45	-16.9%	854	\$3,467	\$4,440	0.2	\$1,144	33.00%
CommBank	46.51	56.29	47.37	-18.8%	215	\$10,000	\$12,102	2.35	\$2,608	26.08%

## Since July 1, 2009

Security Value	\$58,909
Cash Value	\$57,268
Total Value	\$116,177
Total Return (\$)	\$16,176.62
Return Invested (%)	34.61%
Total Return (%)	16.18%
XAO Change	23.90%

## Negative Watch

Company	July 1 price	Price today	Est value	Margin of safety*	Divs rec	Total return
ISOFT	0.635	0.565	0.19	-197.4%		11.02%
Amcors	4.79	6.39	3.63	-76.0%		-33.40%

\* Outperformance of invested portion

10.71%

\* Outperformance of total portfolio

-7.72%

\*\*Last Intrinsic Value update 3/3/2010



Tatts Group argues that it paid similar multiples for Queensland's Golden Casket. In that deal the company paid \$542 million for a business earning just \$35 million in EBITDA. Today Golden Casket earns EBITDA of \$119 million.

As you know, I am more interested in returns on equity and these will be lower than the returns available in bank accounts for some years to come (even more so after this week's interest rate hike).

A major acquisition that generates returns on equity lower than those available in a bank account can only positively impact the intrinsic value of the acquirer if its return on equity was lower to begin with.

While Tatts Group's returns on equity are not impressive since listing – averaging 12.6% since 2007 and expected to average 10–11% for the next two years – they are nevertheless higher than the returns one reasonably expects from the NSW Lotteries acquisition.

Which means, all things being equal, the end result will be a reduction in the company's intrinsic value.

More importantly if 80% of the \$850 million acquisition is funded by debt, the balance sheet of Tatts Group will show interest-bearing liabilities of \$1.6 billion. And while this represents a debt to equity ratio of 58% of the expected \$2.6 billion in equity, that equity is supported by more than \$4 billion of intangible goodwill.

I would argue that a business with \$4 billion of goodwill assets earning returns of less than bank interest should reconsider the true value of those intangible assets. Writedowns, however, are something a business with \$1.6 billion of borrowings can ill-afford.

Tatts will also lose more than \$220 million of EBITDA in 2012 when it relinquishes its Victorian Gaming licence, forcing it to rebid for the new licence.

The acquisition of NSW Lotteries by Tatts Group consolidates its dominant position, adding NSW to its collection of other licences in Queensland, Tasmania, ACT, NT and Victoria.

But a great investment is more than just great assets: you need to buy a business at the right price and the intrinsic value of Tatts Group, currently at \$1.86, is not by my reckoning likely to rise to more than \$2.22 by 2012.

At the current price of \$2.45 a share, you might be better off buying a lottery ticket and sticking that in the bottom drawer! ♦

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