Betfair: Value Extraction Begins.

BUY @ 700p

We met Betfair again to review the early steps taken by the new CEO.

- **The core exchange should be a very strong, highly cash-generative asset with natural monopoly and winner-takes-all characteristics.**
- **New CEO will be aggressive on cost-cutting and value creation. Cost base is far too high as the company overspends on all fronts.**
- **Old pricing structure should be addressed and can drive profit growth ahead of expectations.**
- **£80m of free cash flow not unimaginable, compared with current EV of £600m.**

Company	Betfair plc
Recommendation	BUY
Price	700p
Price Target	1,000p
Upside	+42%
Price Downside	600p
Downside	-14%
Relevant Valuation Metric	Free Cash Yield
Multiple	>10%

As a reminder, Breon Corcoran comes in from Paddy Power - a growing, efficient and successful bookmaker. We think he will bring some best practices on simplicity and cost management to the Betfair organisation. By way of background, Betfair is over-engineered employs too many people doing a lot of needless tasks and has gold-plated commercial, marketing and technology offices at an expensive location in West London. **The core platform is built and should be leveraged now in a more efficient manner to the benefit of shareholders and customers.**

We see the **£20m cost-cutting measures announced at the interim results as a first step on a much larger cost down and efficiency process.** On top of the cost reduction, Betfair will reduce capex, close loss-making businesses and exit businesses where the future value is highly uncertain (e.g. Greece, Cyprus, Germany, LMAX). Some of these businesses are profitable today but Betfair attribute very low NPVs to the those profits due to regulatory uncertainty.

There will be **some short-term pain as restructuring measures and closures are announced but at the end of the process we think Betfair becomes a significantly more profitable and more cash-generative entity.**

As a litmus test, the current EV of Betfair is just £600m. This compares with Paddy Power at >£2.5bn and Perform Group plc at £1bn of market cap. These two businesses aren't directly comparable, but given the attractive core UK exchange at Betfair, we would be surprised if a trade buyer has not had a close look. However, raising debt for a private equity takeover today would be difficult (due to tax and regulatory uncertainty).

1. **Cost down -** we see further opportunities for Betfair to address the commercial team (250 people in various ill-defined marketing roles), the advertising team (a large internal £15m cost item dealing with 32 different ad agencies where they need just 2), the technology team (scope to offshore IT functions to Portugal and Romania with a 50% labour cost advantage) and reduce the overall complexity of the business.

2. **Pricing -** the company has not talked about this, but we note the **appointment of John McElligott from eBay with interest.** We expect him to address pricing in the coming year. Betfair has effectively had the same pricing structure for 12 years. They charge a 5% flat commission with volume discounts available that take average commission to 3-3.5%. Betfair has advantages over traditional bookmakers via the exchange which means **different sports markets and different geographies should be priced differentially according to Betfair's price advantage over the bookmaker**. New pricing structures implemented with confidence to the core customer base are perhaps the biggest potential value driver for the business and are not reflected whatsoever in the share price or any analysts' forecasts. The management haven't confirmed anything here but we suspect it is an immediate focus for the new MD of the Exchange.

3. **Cash flows** - Betfair is at the inflection point on free cash flow. We expect capex to fall considerably in the coming years from >£60m in 2011 and 2012 to around £26m from 2014 onwards. Betfair has net cash of £130m and has conservatively talked about a 40% dividend payout. Realistically, Betfair could have £250-300m net cash in 3-4 years time and will need to address this issue.

4. **Tax and regulation - Betfair and other market leaders should be welcoming a well-policed 15% gross gaming revenue tax in the UK with open arms.** This measure will hit profits significantly but can be offset by pricing and reductions in marketing spend (running around 20-30% of sales in the sector). Although there is some game theory involved and the larger players will have to act rationally under the new tax regime, the disproportionate damage done to smaller, foreign operators would be very beneficial. Furthermore, a properly-taxed and openly-regulated sector with transparent legislation would be a significantly better investment proposition and command higher multiples than the current market.

5. **In the near term,** the market has not welcomed the exit of highly-profitable markets such as Germany, Greece and Cyprus. Around 16% of Betfair's revenue has been identified as non-core for an exit (and this could fall at 30% per year). There is a near-term downgrade to forecasts as a result, but we argue this actually raises the long-term NPV on the totality of Betfair and allows new management to focus.

6. **Reminder of the core asset** - Betfair has over 0.4m active customers in the UK and over 0.4m in Europe. Amongst the core customer base, churn is very low (over 90% of sales are to existing customers) and 2/3rds of the UK revenue is from sophisticated betters. Betfair will try to leverage the core business to grow in the mass market (casual betters) but admits competition is strong here (although the size of the market is multiples). If this strategy fails (and we do not expect a net increase in opex to do this) then it is likely the company retrenches to a simple, cash cow business (or is taken private).

Betfair will announce Q3 results on the 7th March and we see this idea as a slow burn. Over the next 6-12 months we will likely receive more clarity on new management's strategy and this will cause investors to reassess cash flow forecasts and the equity rating on those cash flows.

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THE ANALYST

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