MISTAKES CAN LEAD TO GREAT OPPORTUNITIES

ANTHONY ABOUD
Portfolio Manager
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Most people are familiar with the saying ‘Fool me once, shame on you, fool me twice, shame on me’. Although made famous more recently by George W Bush, it’s genesis is much earlier, found in a book[1] dating from 1651 that cited an Italian proverb: ‘He that deceives me once, it’s his fault; but if twice, it’s my fault.’ In other words, the most important thing that comes from making a mistake is learning from it…and not repeating it.

Investing is no different.

Most of our international investment ideas come from our analysis of ASX-listed companies and stem from our industry research. This can lead us down many pathways as we undertake analysis and gain insights into competitors, suppliers and customers.

Experience enables us to identify those companies which have the best management team, culture, systems and innovation in the industry – over time we determine which company in the sector is best of breed. This is not always the Australian listed company we were analysing in the first place.

Having a flutter in the gaming industry

This is illustrated by our investment in UK-listed Flutter Entertainment; our decision to invest in Flutter originated from one of the biggest mistakes – or learnings – we have made.

When Tabcorp and Tattersalls announced their intention to merge in October 2016, we held a core position in Tattersalls. Its key attraction was its lotteries business, which we believed was infrastructure like with steady cashflows, was under-earning and had a great margin expansion story from shifting distribution from newsagents to online. After much internal wrangling we believed the merger would make sense.

While our exposure to the lottery division would be diluted, we bought the argument that merging the monopoly offline wagering businesses in NSW, Victoria and ACT (Tabcorp states) with the wagering businesses in Queensland, South Australia, Northern Territory and Tasmania (Tattersall states) would make sense.

While both businesses had been losing market share, we felt that the market was starting to consolidate and that a change in taxation structure to point of consumption would level the playing field in favour of the incumbent TAB operators. We also believed this environment would be conducive for the incumbent wagering operators and, if Tabcorp executed well, would generate decent earnings growth to complement the powerhouse lotteries division. We were wrong.

Excluding synergies and comparing like for like, the EBITDA for the combined wagering businesses of Tabcorp and Tattersall's fell 29% from $520m to $370m between FY15 and FY19 and was on track for a further 7% fall in FY20 even before COVID-19 threw things into disarray. This was well below the market's and our own expectations. Share price performance has reflected this.

Where did we go wrong?

Let's start with where we went right. We believed the point of consumption tax would result in further consolidation of the online wagering market in Australia. Over 2018 we saw William Hill merge with CrownBet to make BetEasy, which later merged with Sportsbet. We saw Neds merge with Ladbrokes. We were right about the lotteries business. It has performed extremely well with excellent cashflow, improving margins and strong top line growth.

However, outside of this, Tabcorp has been disappointing. Its investment in online UK wagering was a disaster, its small gaming services division has been awful, and the wagering business has gone from bad to worse.

While analysing Tabcorp's wagering business and trying to understand what went wrong, we've got to know its largest competitor, Sportsbet. During this period, Tabcorp's earnings fell from $520m to $370m, while Sportsbet's earnings increased from $143m to $382m. We acknowledge it's unfair to put these numbers next to each other; Sportsbet is leveraged to fixed odds online sports wagering while Tabcorp is more leveraged to offline horse race wagering totalizator.

There has been a clear shift in consumer preference away from horse racing to sports, away from offline to online and away from tote towards fixed odds. This all helps Sportsbet and hurts Tabcorp.

We also noticed Sportsbet's advertising was more effective, its app easier to use and that it's an innovative company that's quick to move when it identifies new trends. It could do all this and generate profit growth. What impressed us most was that Sportsbet was originally an Australian company, which was bought out by Irish company Paddy Power in 2010, which was subsequently renamed Flutter in 2019.

Sportsbet successfully brought the best learnings from the UK and European online bookmarking market and customised it for the Australian market. Over the years we built up healthy respect for Sportsbet and its parent Paddy Power. The biggest mistake in our Tabcorp thesis was to underestimate how well Sportsbet would compete and how poorly Tabcorp's wagering division would perform.

While we have a bloody nose from our Tabcorp investment, it opened our eyes to an exciting investment opportunity in Flutter.

The simple moral of the story is this – actively learn from your mistakes. You never know what opportunities you may uncover.

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1. https://knowyourphrase.com/fool-me-once