CREDO WEALTH

Down but not out

Our investment strategy involves taking advantage of temporary divergences between share prices and intrinsic value. This necessitates a longer-term investment horizon than next quarter's earnings and an ability to look past current industry trials and tribulations.

Flutter Entertainment plc ("FLTR"), previously Paddy Power Betfair plc, is a sports betting and gaming business with core operations in the UK, Australia and more recently, the United States. Roughly 90% of profits are generated online. The company's strategy is to operate only in regulated jurisdictions, where a substantial market share is achievable, thus enabling economies of scale. Superior scale has allowed FLTR to generate industry leading margins in core markets, whilst providing competitive odds, offering a great customer experience and reinvesting in their brands.

2018 will be remembered as an "annus horribilis" for both the industry and investors. Regulators in the UK, Australia and Ireland all imposed taxes and consumer protection restrictions, which cumulatively slashed FLTR's profit by around 26%. As shareholders, we were significantly impacted, not just by the fall in earnings but also by the knock to investor sentiment. Whilst this has been a painful period, we continue to believe that there is substantial long-term value in these shares.

Counterintuitively, the new regulations place the company in a stronger competitive position. Higher taxes and consumer protections will accelerate the secular shift in wagering, away from brick and mortar and towards online, as the industry closes retail stores that are made unprofitable. In the UK, the limit imposed on fixed odd betting terminals is expected to result in the shutdown of around a third of retail betting shops. FLTR's relatively small retail estate means that its earnings have been less impacted than others, meanwhile the larger online business will benefit. In Australia, the increase in online taxes has reduced profitability across the industry, but the impact has not been evenly felt. Larger operators have been able to leverage their scale advantage and gain market share, as the weaker players exit, or consolidate. Indeed, FLTR's Australian wagering growth has accelerated, and the company is growing market share. Consolidated markets, with higher barriers to entry tend to be more profitable, which bodes well longer term for the UK and Australia. Given the magnitude of the regulatory changes, we believe that the company's earnings have now largely de-risked.

Ironically, 2018 also gave birth to what is likely to be the largest new market opportunity in sports betting in our lifetime. The US Supreme Court repealed the federal law banning sports betting, which has allowed individual states to legalise the market. We believe the long-term potential of the US opportunity is massively underappreciated. US GDP is around 7 times greater than the UK and the population is around 5 times larger. Currently only around a third of states are projected to legalise within the next 5 years. However, we calculate that these states would be roughly equivalent to twice the size of the UK in terms of GDP and 1.5 times the population. We believe that further into the future, many more states will seek to legalise sports betting due to popular demand from voters and as a source of tax funding.

We believe that FLTR is best placed to be the leading player in US sports betting for the following reasons:

1. Licencing a sportsbook in most states requires a partnership with existing casinos and racetracks, who lack the expertise. FLTR already has relationships with racetracks through TVG, their nationwide online "tote" business. FLTR is also one of the largest omni-channel sportsbook operators globally, with experience operating across multiple regulated markets.

2. We believe that around 90% of US wagering will eventually be conducted online. Already, in New Jersey, having been legal for just a few months, roughly 80% of wagers are being conducted online. This is because of the limited number of retail venues and convenience of online registration. FLTR currently operates leading online sportsbooks in the UK (#2) and Australia (#1), so it can leverage its global trading platform and technology.

3. Operating leverage will be very high, therefore, achieving scale will be critical to long-term profitability. FLTR acquired Fanduel, a Fantasy Sports company which allows customers to pay to enter sports-based, online competitions for prize money. Fanduel provides FLTR with a unique opportunity to cross sell sports betting to an existing customer base with a very high propensity to bet on sports, thus accelerating the speed at which the company can gain scale. We are seeing this play out in New Jersey, where FLTR currently has around 55% market share.

Whilst FLTR has significant advantages which we believe mean that the company will win in the long term, significant investment is required in the short term to ensure that the company is in the best possible position. These investments will depress earnings in 2019. Thereafter, earnings should bottom out as start-up losses in the US trough and then accelerate over the medium term, leading to a multiple re-rating. Ben Graham noted that "in the short run the market is a voting machine but in the long run it is a weighing machine". We think FLTR is a heavyweight.

Important notice