Coming Together

No company operates in isolation, and few stay in the same shape and form. As bottom up stock pickers, one approach to outperform is to look for opportunities in areas where the bigger forces are pushing against the old models in ways where value can still be salvaged. The stock price can underperform excessively when the downside is well recognised, at the expense of overlooked or oversimplified positive outcomes.

Ladbrokes is a Britain-based betting and gaming company. It started life in 1886 as a commission agent for horses trained at Ladbroke Hall (Warwickshire). Operating in a highly regulated industry, it was the Betting and Gambling Act of 1961 that legalised betting shops, and led to the well-recognised chain with about 3,500 shops.

It has been a difficult last decade for the company. Like many other retailers, the internet has provided an easy alternative to needing to visit a physical store.

On top of this, the Government has become increasingly concerned with gambling addiction. In December 2014, a point of consumption (POC) tax was introduced, charging 15% on all bets made by UK customers irrespective of where the operator is located. A Triannual review is now looking at ways to reduce the negative impact on punters who lack self-control. Suggested methods include reducing how much can be wagered on a single spin, how much time there is between spins, and how much can be lost in one session.

Faced with the twin waves of the internet and regulation, the gaming sector has been going through a series of consolidations. The Government is happy with this. It means fewer participants, and fewer participant makes effective regulation easier.

It also provided us with an opportunity. Ladbrokes has a large retail exposure, and the Triannual review could have far reaching implications on its land based business model. For these reasons, it had been shunned by investors. We reviewed the business model and took the view that the market had been too negative. Even if the maximum spin was reduced from £100 to £2, they could close some shops and restructure the business. Given the job losses and cost to HMRC, we view this extreme outcome as unlikely.

Once the review is out of the way, there are unexploited opportunities, including an underutilised online presence. Add to that the trend of consolidation.

We viewed Ladbrokes as an obvious target for GVC – a multinational sports betting and gaming group licensed in more than 18 jurisdictions. They had been in merger discussions as recently as 3 months ago, and GVC has just sold its Turkish business. This was possibly one of the stumbling blocks in the original negotiations. GVC has a strong merger and acquisitions track record (e.g. Sportingbet and bwin.party). The CEO has consistently stated that he would like to have a larger presence in the UK betting market. Besides the cost reduction benefits of coming together as one company, there could be fantastic opportunities to cross sell. Ladbrokes would get exposure to GVC online operations, and (even as the physical shops struggle) GVC would get access to potential new online customers.

The price jumped dramatically when news of fresh merger talks was confirmed in early December. At this point, there has been no formal offer or acceptance from Ladbrokes. The jump simply reflects the market's confidence that the deal will go through. £1.1bn of combined operating costs could result in more than £120m in savings. The combined group will be a candidate for the FTSE 100 with a good geographic and product balance, and high exposure to regulated markets.

The point is not that we get every call correct, or the fortunate timing in this case (it is worth remembering that the merger still needs to go through the process). The point is that negative trends can provide pleasing results to those willing to do the work on whether that pessimism is fully justified. Businesses are dynamic, and those that can recognise change, and adjust, can have their resilience rewarded. Even if it is in a new form.

Important notice