

UK Gaming

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ASSUMING COVERAGE

Favouring low-risk structural growth

We see three key themes driving returns in the medium term: As Tal Grant assumes primary coverage of UK Gaming, Paddy Power Betfair is now our preferred stock in the sector: with its P/E multiple relative to the FTSE 100 now at decade lows, we upgrade to Outperform (new TP £92). We downgrade Ladbrokes Coral to Underperform (new TP 110p) as we see more risk to it than to William Hill (Neutral, new TP 240p) from the Triennial Review.

In a [separate report](#) also published today, we initiate coverage of gaming software supplier Playtech with an Outperform rating and £12 TP.

Key themes for the sector:

(1) The shift from retail betting to online – We expect continued relative growth for online players. This drives our medium-term assumptions: +9% EPS CAGR for Paddy Power Betfair (PPB) in 2018-21E, +8% for Playtech, +3% for Ladbrokes Coral (LCL), and +2% for William Hill (WMH).

(2) Regulation – We explore seven known and mooted regulatory changes across the globe. In the near term, we view the UK government's Triennial Review as a key binary event for WMH and LCL. We believe the risk of the maximum stake for gaming machines being cut to £2 from £100 has materially increased since the UK election. The Review process appears misunderstood by the market, driving a mispricing of this risk. To determine its impact, we have used public and private data to build a proprietary bottom-up model of the entire UK Licensed Betting Office market, with estates divided by deciles of differing quality.

We use the latest Gambling Commission dataset on machine use (February 2017) to determine customer behaviour following a stake limit change. Based on the impact this has on the various shop deciles, we model some shop closure mitigation. We conclude that a £2 limit would hit Group profits by c40% at WMH and c50% at LCL, with c1k shop closures between them (at a combined cost of c£200m).

(3) Technology – We think WMH and PPB have the best technology strategies, and in the tests we have run – across user experience, latency, and bet settlement speeds – their apps perform best. This drives our relative UK online sports-betting market share assumptions in 2017-20E (PPB: +30bps pa; WMH: +10bps pa; LCL: +0bps pa).

Figure 1: New stock ratings and target prices

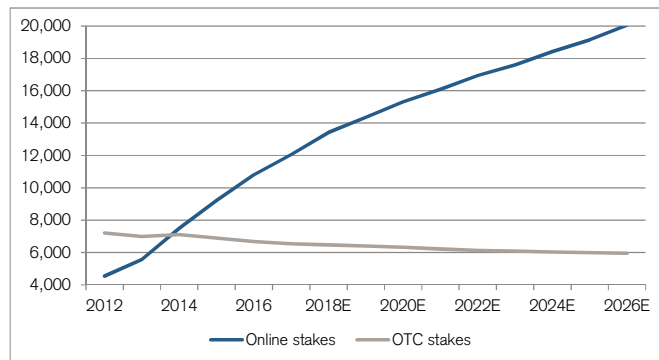
	New Rating	Old Rating	New Target Price	Old Target Price	Upside/(downside)
Paddy Power Betfair	Outperform	Neutral	9,200p	8,900p	+27%
Playtech	Outperform	Not covered	1,200p	Not covered	+24%
William Hill	Neutral	Neutral	240p	306p	(6%)
Ladbrokes Coral	Underperform	Neutral	110p	133p	(14%)

Potential up/downside based on prices as of 8 August 2017; Source: Credit Suisse estimates

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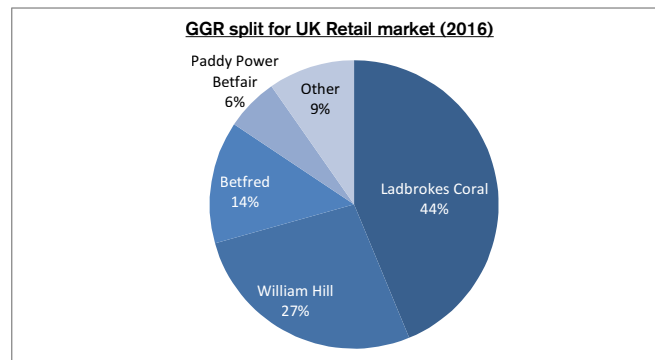
Key charts

Figure 2: The shift from retail betting to online...



Source: Credit Suisse estimates; Aggregate of PPB, LCL, and WMH (£m)

Figure 3: ...is an issue for retail-heavy UK operators



Source: Credit Suisse research, Companies House, H2 Gambling Capital

Figure 4: And while regulatory risks abound...

7 Key risks:	
I) Triennial Review: FOBTs	IV) Australian regulation
II) Triennial Review: advertising	V) US regulation
III) UK online regulation	VI) Global regulatory trends
	VII) China regulation

Source: Credit Suisse research

Figure 5: ...the risk to retail is particularly acute

	LCL	PPB	PTEC	WMH
I) Triennial Review: FOBTs	(45%)	(6%)	(7%)	(42%)
II) Triennial Review: advertising	--	--	--	--
III) UK online regulation	(7%)	(5%)	(2%)	(8%)
IV) Australian regulation	(5%)	(12%)	--	(6%)
V) US regulation	--	--	--	+2%
VI) Global regulatory trends	--	--	+5%	--
VII) China regulation	--	--	(72%)	--

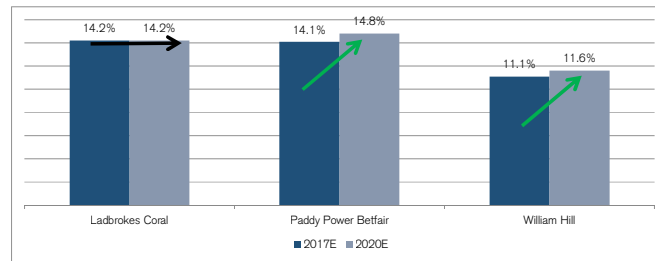
Source: Credit Suisse estimates of 2018E EBITDA tailwinds/headwinds from regulation

Figure 6: WMH and PPB's technology are leading...

UX Test	Taps	Bet Settlement Test	Time	Latency Test	Time
Bet365	4.0	William Hill	00:56	William Hill	11s
Betfair Exchange	4.0	Paddy Power	01:13	Paddy Power	11s
Betfair Sportsbook	4.0	Sky Betting & Gaming	01:14	Sky Betting & Gaming	13s
Ladbrokes	4.0	Coral	01:32	Coral	13s
William Hill	4.0	Bet365	01:52	Bet365	14s
Paddy Power	5.0	Ladbrokes	02:03	Betfair Sportsbook	14s
Sky Betting & Gaming	5.5	Betfair Sportsbook	02:04	Betfair Exchange	17s
Coral	6.0	Betfair Exchange	07:16*	Ladbrokes	32st

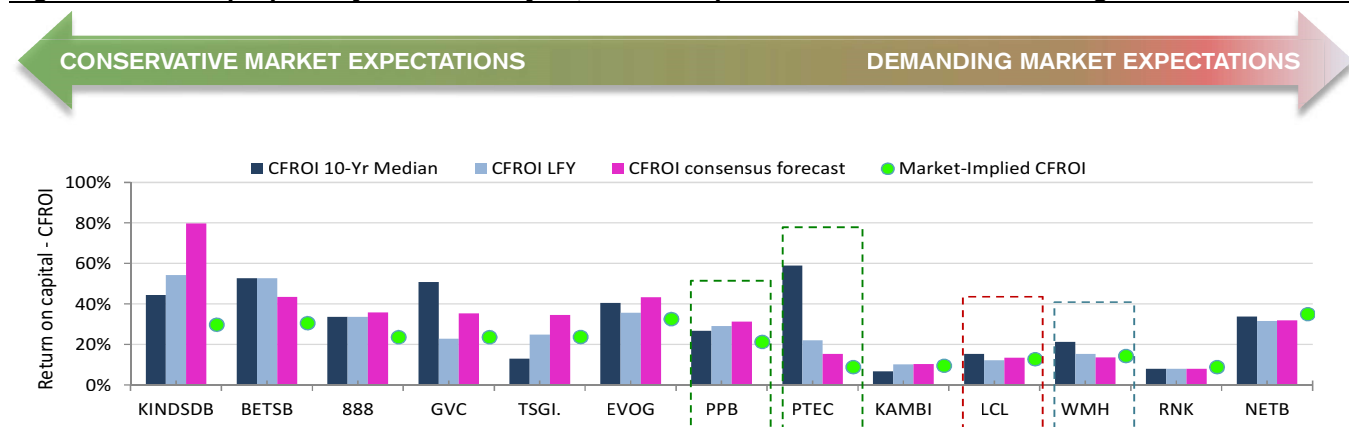
Source: Credit Suisse research; *one outlier hurt results; †no single sign-on when we tried

Figure 7: ...driving our market share assumptions



Source: Credit Suisse estimate of UK online sports-betting stake market share

Figure 8: Per our proprietary HOLT® analysis, market expectations are least demanding for PPB and PTEC



Source: Credit Suisse HOLT®

3. Technology as a differentiator

In this section, we:

- Make a case for operators owning more of their technology;
- Compare the technology strategies of the key players in the UK market;
- Compare the consumer apps of the key players in the UK market.

Given the shift to online gambling discussed above, having the right technology strategy is critical. Ultimately, we see betting companies' key business being a consumer app in time. As such, we believe technology strategy should focus on:

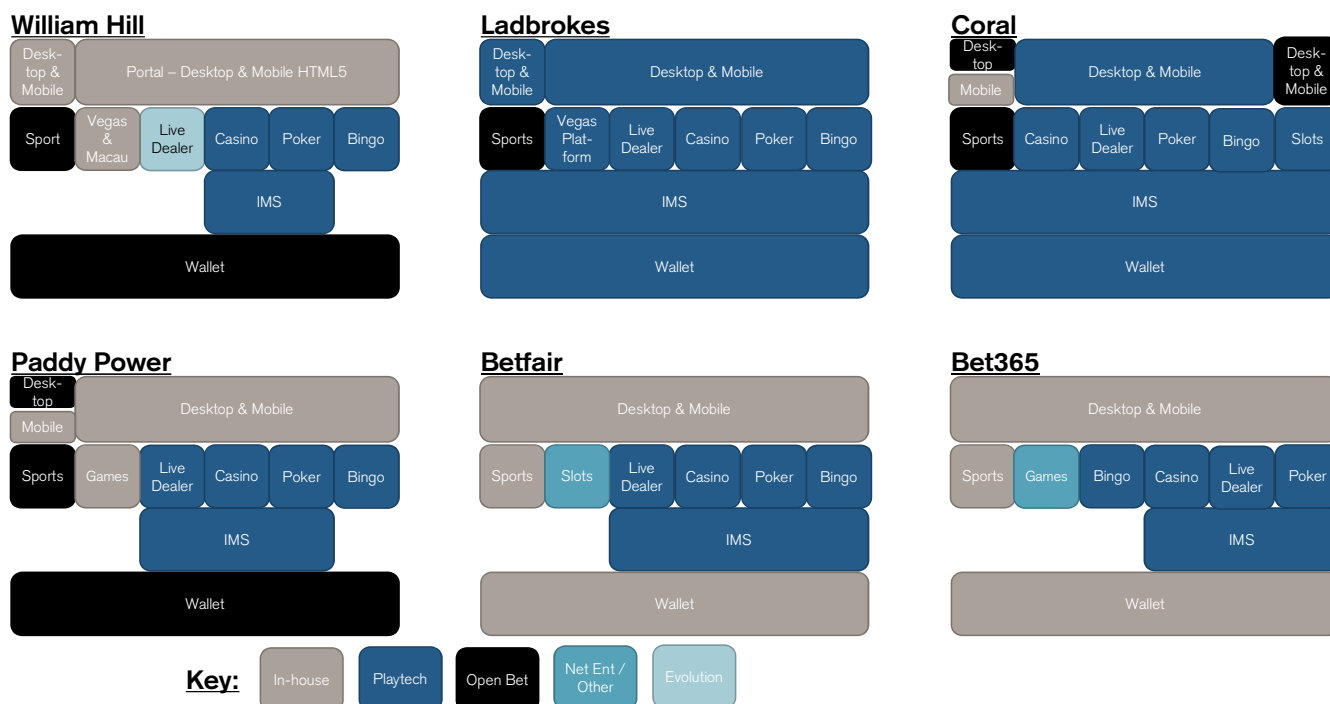
- a) User experience (UX);
- b) Product innovation;
- c) Speed.

We find that William Hill and Paddy Power Betfair rank highest across a range of tests we conducted to measure these metrics. Furthermore, we believe there is room for improvement for both names as William Hill continues to re-write code in Erlang and as Paddy Power completes its migration to the Betfair platform, which we believe is best-in-class. Ladbrokes Coral lags slightly in the tests and we are less convinced on its technology strategy.

Is in-sourcing technology important?

The three stand-out performers in the industry over the past five years – Bet365, Sky Betting & Gaming, and Betfair – have all owned and made significant investments into their proprietary tech stacks and customer facing apps. William Hill and Paddy Power are moving towards this model (Figure 117).

Figure 117: Differing tech stacks at operators



Source: Credit Suisse research

But does it matter?

Owning the front-end (which all but Ladbrokes Coral do or are planning to do in the near term) allows operators to observe the customer journey. Thus, any pain points along the journey to place a bet can be addressed directly for example. There is no reason to believe that an outsourced partner like Playtech's Mobenga mobile front-end solution would not be able to observe the same issues and make similar UX improvements. However, by taking the front-end in-house, an operator's lead on the competition is likely to be greater if it can identify a way to reduce the number of taps to make a bet, for example (whereas Mobenga would share such an innovation with their other licensees).

There is also the question of deploying new products quickly and protecting new product ideas. William Hill notes that in 2012, it was held up by Open Bet programmers when it was looking to deploy Cash Out functionality. And furthermore, Open Bet then owned much of the code and was able to distribute it to its other licensees.

Is product innovation important?

A key question is whether technology investments into new products are worthwhile or whether they are copied too quickly to provide a value-creating return on investment. We would argue that there is a case to be made for investing in product innovation given the success of these products:

- **Exchange** – Since raising £1m from friends and family, with no patent, Betfair has maintained 90%+ of the sports-betting exchange market for almost 20 years. We view it as a significant differentiator for Paddy Power Betfair.
- **In-play** – Bet365 first mentioned in-play betting in its 2007 Annual Report published in June 2007. At the time, Bet365's revenues were half of William Hill's online sales. William Hill had some manual in-play trading in 2008, but did not roll out a full offering until July 2009. Bet365 is now more than two times larger than William Hill's online division in terms of sales. More than 70% of its wagers are in-play versus 40-50% at William Hill Online.
- **Cash Out** – William Hill launched Cash Out functionality for its sportsbook in December 2012. It took Betfair Sportsbook until May 2013 to follow suit and Paddy Power until November 2013 (for singles) and March 2014 (for accumulators). Ladbrokes did not launch until 2015. This gave William Hill a reasonable run-time to outperform and this period in which it had this competitive advantage marked a period of significant market share gains.
- **Contingent liability betting** – Sky Betting & Gaming launched “#RequestABet” as a marketing campaign via Twitter in 2012 and has since rolled it out into a standalone product. It allows users to place bespoke bets, including bets on contingent liability events (e.g. Manchester United to score and Lukaku to score). William Hill recently launched a similar product, “#Yourodds”. 2m “#Yourodds” bets were placed in the first half of 2017 at a better gross win margin than that observed in the rest of the online division. Paddy Power Betfair launched automated same-game multiples in Australia in 2017. We believe this is a unique capability to it.

Why we like Paddy Power Betfair's tech strategy

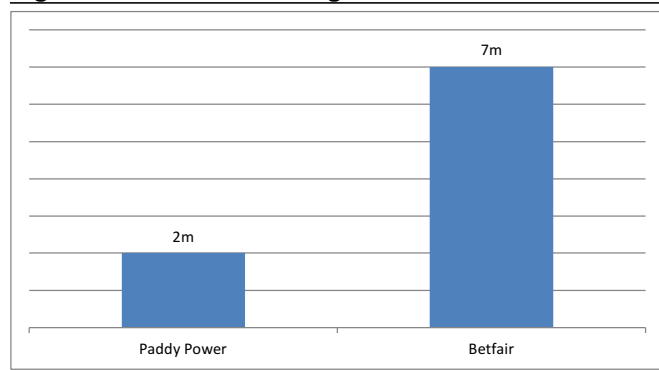
After a cautious Q1 call with analysts, where Paddy Power Betfair CEO Corcoran discussed increasing sports-betting competition and questioned whether the company could keep up with 'softer' eGaming companies in online gaming, investor and analyst sentiment around the company has worsened. The stock is down 17% year-to-date.

On the sports-betting side, while we acknowledge there may be short-term risks from aggressive pricing from competitors, we think the combination of Paddy Power's risk trading experience with Betfair's technological nous will matter more in the long run than short-term unsustainable discounts from competitors.

Betfair Sportsbook is already able to offer more games since the merger than it did previously (e.g. by August 2016, it was offering 2x more tennis matches than before the merger). Both sportsbooks are now using the newest football model, which has resulted in a 90% reduction in the average market suspension time compared with the previous model. This means that, on average, consumers will only be unable to bet in-play for less than one minute per each 90-minute football match. The new model also results in <0.1% of in-play bets failing. This is a 97% reduction compared to the old model. Across the Group, 19 sports are priced via in-house models. This is important as it allows more room for innovation and differentiation. For example, the new NBA model used by Australian brand Sportsbet has 193% more pre-match betting markets. At the 2017 NBA Finals, 29% of active customers placed bets on these additional markets. These bets represented >10% of NBA finals stakes.

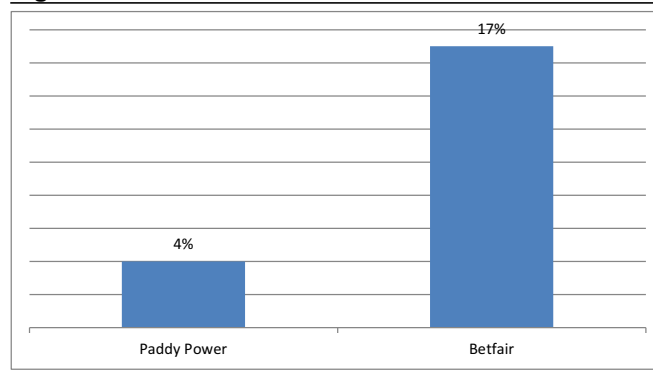
In terms of the technological advantage that the Betfair heritage will afford Paddy Power, we point to the Cash Out functionality. Betfair developed this in-house and was able to offer the functionality to customers for both singles bets and accumulators by May 2013. It was used 7m times in 2015 (Figure 118) and for 17% of football stakes (Figure 119). Paddy Power, by contrast, had to develop this using a third party (Open Bet), which also meant that the IP belonged to Open Bet. It launched for single bets in November 2013 and only on accumulators in March 2014. As a result, it is less closely associated with Paddy Power. Just 2m bets were cashed out in 2015 and only 4% of football stakes.

Figure 118: Cash Out usage in 2015



Source: Company data

Figure 119: % of football stakes cashed out in 2015



Source: Company data

On the eGaming side, we believe there will be a step change in 2018 once the integration work with Betfair is completed. Currently, 60-70% of the company's European IT staff is focused on the integration work (Figure 120). Once this is completed (end of this year), there will be opportunities for new product innovation to help boost eGaming revenue growth *and* possibly for cost-cutting.