

31 May 2007

Leisure & Gaming

Year End	Revenue (€m)	PBT* (€m)	EPS* (€c)	DPS (€c)	PE (x)	Yield (%)
12/05	207	1.4	7.6	0.0	3.9	0.0
12/06	479	7.5	11.1	0.0	2.7	0.0
12/07e	150	2.5	2.3	0.0	12.9	0.0
12/08e	225	6.8	6.0	0.0	4.9	0.0

Note: *PBT and EPS are normalised, before exceptional charges (€90m in 2006) and goodwill amortisation. All figs now in € (£1=€1.46), having previously been reported in US\$.

Investment summary: AGM update

Leisure & Gaming (L&G) has announced mixed trading at Betshop, with EBIT growth of 31% for the first four months of the year more than offset by losses in May due to adverse sporting results. As a result we have lowered our current year forecast from PBT €3.4m to PBT €2.5m. Betshop has built up a strong distribution network in the liberalising Italian market and the introduction of new products later this year should boost results and reduce earnings volatility.

Healthy growth offset by a poor May

Betshop's 2007 turnover to date is nearly double 2006 levels, helped by the rapid growth in new franchise shop openings. Net win to the end of April was up by 71% but adverse sporting results in May (notably Milan's win in the Champion's League) have left the group in a loss making position at the EBIT level for the first five months of the year. The underlying message is that the business continues to grow and revenues are in line with management expectations, but it is currently over-exposed to a single product and market, as the volatility over the Champion's League has demonstrated.

Expansion opportunities

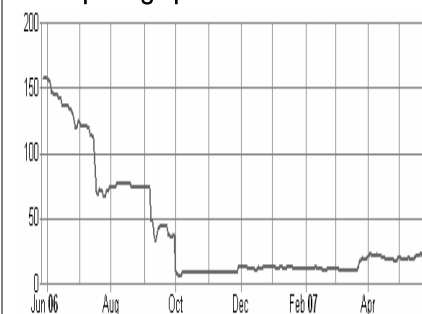
Betshop's 60 new licences should allow the introduction of a much greater range of products later this year and into 2008, once the government has finalised the types of games it will allow. These could include pool betting, bingo, casino and poker. These fixed margin games should go some way to reducing the volatility of results. Betshop also plans to roll out a similar franchise model in new emerging European markets, starting with Romania where it already has a sportsbetting licence.

Valuation: Prospective PE of 12.9x

L&G's shares have rebounded since our last note (22 March) but at 12.9x 2007 earnings are still at the lower end of the peer group. The impact of May's losses highlight earnings volatility with further diversification needed to justify a higher rating.

Price 20.25p
Market Cap £14m

Share price graph



Share details

Code LNG
Listing AIM
Sector Travel & Leisure
Shares in issue 71.4m

Price

52 week High 167p Low 5.5p

Balance Sheet

Debt/Equity (%) N/A
NAV per share (€c) 25
Net cash (€m) 0.9

Business

L&G's main business is Betshop (acquired 23 June 2006), a European sportsbetting business with over 1,100 branded franchise shops, mainly in Italy. L&G sold its US-facing operations in October 2006.

Valuation

	2006	2007e	2008e
P/E relative	8%	52%	18%
P/CF	2.1	4.4	1.6
EV/Sales	0.0	0.1	0.1
ROE	39%	7%	7%

Geography based on revenues

UK	Europe	US	Other
2%	98%	0%	0%

Analyst

Jane Anscombe 020 7190 1756
janscombe@edisoninvestmentresearch.co.uk

Betshop

Betshop's key strength is its management expertise and the sizeable network of franchise shops it has built up in the liberalising Italian market. There are now over 1,100 shops in the Betshop Italia network, almost double the number at the time of Betshop's acquisition in June 2006, and the franchise model means that they have been opened with minimal capital outlay. Betshop Italia currently contributes about 80% of turnover, with Betshop.com and GoalsLive the balance.

Exhibit 1: Betshop growth to April 2006

Note: 2005 and 2006 figures previously reported in US\$ (re-presented using US\$1=€0.792)

€m	2005 Year	2006 Jan-Apr	2006 Year	2007 Jan-Apr
Turnover	26.6	23.3	92.4	44.6
% growth			+247%	+91%
Net win	7.5	7.0	21.7	11.9
% growth			+187%	+71%
Net win margin %	28.3%	30.0%	23.5%	26.7%
EBIT		0.8	(0.6)	1.1
% growth				+31%

Source: Leisure & Gaming/Edison Investment Research

Up to the end of April Betshop's profits were growing very strongly, as shown in Exhibit 1. We believe that May turnover was again almost double the 2006 level, but adverse results including the Italian win in the Champion's League produced a gross loss of approximately €1.4m for the month. This wiped out earlier gains to produce an EBIT loss for the first five months. As a result we have reduced our full year forecast, although the strong growth in footfall and turnover still bodes well for results in the second half (which will compare with losses over the 2006 World Cup period). The introduction of new products should boost results from Q4 and more particularly in 2008. We have left our 2008 forecasts unchanged (aside from the re-presentation from \$ to €). The normal monthly fluctuations in sports win margins obviously make forecasting difficult, but going forward product diversification should help reduce margin volatility.

New licences

Betshop now has 60 new licences, all for non-dedicated 'corners' (38 for horse-betting and the rest for sports). The Italian government is still finalising details of the new products that will be allowed, expected to include pool betting, bingo, casino, skill games and possibly poker. It is possible that additional licence payments will be required for the new games, and the software will also need to be approved. The timetable is taking longer than we originally hoped due to government delays, but we had prudently not included any material contribution in our earlier forecasts. The process is still broadly on track and could provide significant upside for the group in 2007 Q4 and 2008.

New markets

L&G's 2006 Annual Report sets out its "differentiated approach", focusing on emerging European markets with a business model that combines an online service with a land-based franchise network. Betshop has worked hard over the past two years to develop market knowledge and

relationships in countries such as Romania, Greece and Lebanon. It already holds a sportsbetting licence in Romania, and said that it plans to enter that market during 2007.

Leisure & Gaming group overview

L&G's interim results for the six months to June 30 will reflect the significant change in the group's composition over the last year. 2007 results mainly comprise Betshop, together with the small Grouse online casino (whose losses have been successfully eliminated) and very modest central costs. We expect a loss for the period. 2006 first half results mainly comprised the now discontinued US-facing operations. Since Betshop was only acquired on 23 June 2006 the continuing operations will show minimal turnover for the first half of 2006 (only Grouse) and a loss after administration costs (including central costs for the enlarged group). Our full-year forecasts for 2007 and 2008 are shown in Exhibit 3 (re-presented in euros using US\$1= €0.75).

Balance sheet and cash flows

In November 2006 L&G successfully secured releases from previous earn-out obligations and refinanced the company, putting the group on a sound financial footing with €0.9m of net cash (excluding client funds) at the year-end. In January 2007 it paid €1.7m to acquire the new Italian licences. The group should be cash generative in 2007 although, as we noted in March, significant new product or geographic expansion could require additional working capital. The share reorganisation approved at yesterday's AGM allows equity as well as debt financing if appropriate. Betshop earn-out payments are based on achieved EBIT - on our revised estimates there is no 2008 liability (based on the 2007 forecast) and around €1.5m would fall due in mid-2009 (which may be satisfied as to 50/50 in cash and shares).

Valuation: Peer group comparison

Despite a recovery in L&G's share price since March its valuation still appears low compared with the rest of the online gaming sector. In part this reflects the much broader product and geographic spreads of the larger operators, who have greater cross-selling opportunities and lower earnings volatility. However, L&G's differentiated approach could justify a higher rating.

Exhibit 2: Peer group comparison based on forecast earnings to December 2007

Note: Exchange rates used: £1 = US\$1.94; £1=€1.46. Share prices at 30 May 2007

Company	Price (p)	Mkt Cap (£m)	Pretax (£m)	EPS (p)	EV/EBITDA (x)	P/E (x)
PartyGaming	41	1,687	40.0	0.9	31.8	44.4
888 Holdings	113	381	22.7	6.4	13.3	17.6
Sportingbet	51	221	11.0	2.3	15.9	22.2
32 Red	43.4	30	0.8	1.4	20.0	31.1
Ladbrokes	407	2,560	203.0	25.5	16.9	16.0
Paddy Power	1,517	777	38	6.2	15.9	23.6
Leisure & Gaming	20.25	14	1.7	1.6	8.0	12.9

Source: Hemscott consensus forecasts/Edison Investment Research

Exhibit 3: Financials

Note: Results and forecasts now reported in €, re-presented using average rates of US\$1=€0.792 for 2006 and US\$1=€0.75 for 2007/8.

Year-ending 31 December	2005	2006	2007e	2008e
Accounting basis: IFRS	16 mth			
€m				
PROFIT & LOSS				
Revenue	207	479	150	225
Net win	18.5	73.2	36.6	56.3
EBITDA	1.3	8.0	2.7	6.9
Operating Profit (before GW and except.)	1.1	7.9	2.6	6.8
Goodwill Amortisation	0.0	(2.9)	(0.1)	(0.1)
Share options	(1.0)	(0.4)	0.0	0.0
Exceptionals	0.0	(86.9)	0.0	0.0
Operating Profit	0.2	(82.2)	2.5	6.7
Net Interest	0.3	(0.4)	(0.1)	0.0
Profit Before Tax (norm)	1.4	7.5	2.5	6.8
Profit Before Tax (FRS 3)	0.5	(82.6)	2.4	6.7
Tax	(0.3)	(0.5)	(0.8)	(2.1)
Profit After Tax (norm)	1.1	7.0	1.7	4.7
Profit After Tax (FRS 3)	0.2	(83.1)	1.7	4.6
Average Number of Shares Outstanding (m)	14	63	73	78
EPS - normalised fully diluted (c)	7.6	11.1	2.3	6.0
EPS - FRS 3 (c)	7.8	(132.0)	2.3	6.0
Net win margin (%)	9%	15%	24%	25%
EBITDA Margin (%)	1%	2%	2%	3%
Operating Margin (before GW and except.) (%)	1%	2%	2%	3%
BALANCE SHEET				
Fixed Assets	94.3	31.4	33.2	33.3
Intangible Assets	93.2	31.4	33.0	32.8
Tangible Assets	1.2	0.0	0.2	0.5
Investment in associates	0.0	0.0	0.0	0.0
Current Assets	31.2	5.6	5.1	9.0
Stocks	0.0	0.0	0.0	0.0
Debtors	16.9	1.9	3.1	4.0
Cash (net of client funds)	17.0	3.7	2.0	5.0
Current Liabilities	(13.6)	(7.2)	(6.5)	(7.0)
Creditors	(13.6)	(5.4)	(6.0)	(7.0)
Short term borrowings	0.0	(1.8)	(0.5)	0.0
Long Term Liabilities	(14.6)	(11.8)	(11.2)	(6.5)
Long term borrowings	0.0	(1.0)	(0.5)	(0.5)
Other long term liabilities	(14.6)	(10.8)	(10.7)	(6.0)
Net Assets	97.3	18.0	20.6	28.8
CASH FLOW				
Operating Cash Flow	3.8	3.7	1.6	6.0
Net Interest	0.1	(0.2)	(0.2)	0.0
Tax	0.0	(0.3)	(1.0)	(1.5)
Capex	(1.6)	(3.1)	(0.5)	(1.0)
Acquisitions/disposals	(31.9)	(16.9)	0.0	0.0
Financing	46.6	4.4	(0.0)	0.0
Dividends	0.0	0.0	0.0	0.0
Net Cash Flow	17.0	(12.5)	0.0	3.5
Opening net debt/(cash)	0.0	(14.3)	(0.9)	(1.0)
HP finance leases initiated	0.0	0.0	0.0	0.0
Loans acquired with acquisitions	0.0	0.0	0.0	0.0
Other	0.0	(0.9)	0.1	0.0
Closing net debt/(cash)	(17.0)	(0.9)	(1.0)	(4.5)

Source: Company accounts/Edison Investment Research

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Edison Investment ResearchBracton House, 34-36 High Holborn, London, WC1V 6AE ■ tel: +44 (0)20 7190 1760 ■ fax: +44 (0)20 7190 1759 ■ www.edisoninvestmentresearch.co.uk
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