

22 March 2007

Leisure & Gaming

Year End	Turnover (US\$m)	PBT* (US\$m)	EPS* (c)	DPS (c)	PE (x)	Yield (%)
12/05	261.1	1.7	9.6	0.0	2.1	N/A
12/06	604.4	9.5	14.0	0.0	1.4	N/A
12/07e	200.0	4.5	4.2	0.0	4.7	N/A
12/08e	300.0	9.0	8.1	0.0	2.5	N/A

Note: *PBT and EPS are normalised, before exceptional charges of £113.3m in 2006. All figs in US\$, £1 = US\$1.94 (although LNG intends to report in Euros from 2007 onwards).

Investment summary: Betshop growing strongly

Leisure & Gaming (LNG) has reported strong underlying growth in its continuing Betshop operations and an encouraging start to 2007. Final results were distorted by the discontinued US-facing operations, but the group has a sound balance sheet and good growth potential, with its franchise model both in Italy and in new emerging markets such as Romania.

Final results impacted by discontinued US operations

LNG's 2006 P&L provided little real guidance as to the performance of the business going forward for two reasons: results were dominated by the discontinued US operations, and the continuing businesses only included Betshop for six months. The attributable loss of US\$105m (after US\$113m of exceptional charges) was in line with our forecast and year-end net cash of US\$1.2m was better than we expected.

Encouraging start to 2007

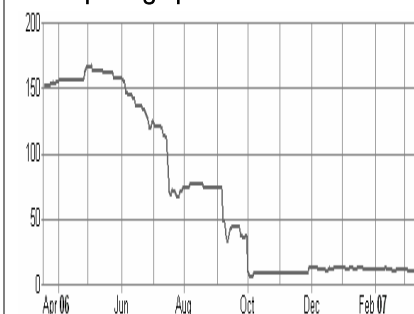
Betshop's turnover and net win is currently running at double the equivalent period in 2006, reflecting the rapid growth in franchised shops, and 2007 sports margins should be better than last year. Our pre-tax forecasts are currently unchanged but there is upside from the introduction of new products, the 58 new licences and geographic expansion into licensed markets such as Romania.

Valuation: Not yet reflecting growth prospects

With a difficult 2006 now behind us the market should focus increasingly on Betshop's established position in the liberalising Italian market and elsewhere. Risk factors include the business's short track record, fluctuating sports margins and potentially increased competition from larger operators. However, online gambling is growing very strongly and the 2007 P/E of less than 5x is well below the peer group and does not reflect the restored balance sheet, good growth prospects or likelihood of M&A activity in the sector.

Price 10.25p
Market Cap £7m

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) 38
Net cash (US\$m) 1.2

Business

Post the sale of its US-facing business LNG comprises Betshop, a European sportsbetting business with an online operation and 1,100 branded franchise shops, mainly in Italy.

Valuation

	2006	2007e	2008e
P/E relative	9%	37%	21%
P/CF	2.6	4.9	1.9
EV/Sales	0.0	0.0	0.0
ROE	37%	11%	11%

Geography based on revenues

UK	Europe	US	Other
5%	95%	0%	0%

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Results and forecasts

Our Outlook report dated 29 November described LNG's forced disposal (for US\$1) of its US-facing operations on 13 October (prior to the passing in the US of the *Unlawful Internet Gambling Enforcement Act*) and its successful financial reorganisation. Post the disposal, LNG's main business is Betshop, a European betting and gaming business acquired in June 2006.

Exhibit 1: Results and forecasts

Note: 'Continuing' includes Betshop for 6 mths; 12 mths data includes pre-acquisition trading from 1.1.06.

US\$m	2006 Group	2006 Continuing	2006 Betshop 12mths	2006 Betshop % incr	2007E Year	2008E Year
Turnover	604.4	74.2	116.7	+247	200.0	300.0
Net win	92.4	18.1	27.4	+187	50.0	75.0
Net win %	15.3%	24.4%	23.5%		25.0%	25.0%
Gross profit	41.8	2.1			12.7	18.0
Admin expenses	(31.3)	(6.8)			(8.0)	(9.0)
Share options	(0.5)	(0.5)			0.0	0.0
EBIT (norm)	10.0	(5.2)			4.7	9.0
Exceptional items	(113.3)	(7.1)			0.0	0.0
Net interest	(0.5)	(0.5)			(0.2)	0.0
Pretax profit/(loss) (norm)	9.5	(5.7)			4.5	9.0
Pretax profit/(loss)	(103.8)	(12.8)			4.5	9.0

Source: Leisure & Gaming/Edison Investment Research

The discontinued US-facing businesses dominated LNG's 2006 results, contributing \$530m to turnover and \$15.2m to clean EBIT. Betshop contributed \$73m to turnover and around \$2.2m to gross profit in the six months post acquisition. Its turnover was ahead of our forecasts reflecting strong growth in customers, but unfavourable football results (and thus sports win margins) left gross profit below target. Grouse (the small Acropolis branded online casino, which stopped accepting US customers in October) contributed US\$1.6m to turnover and made a small operating loss. The continuing business bore group overheads for the entire period producing an EBIT loss of \$5.2m; since October, management has moved swiftly to cut central costs by 75%.

Exceptional items totalled \$113.3m in 2006 although only \$1.8m were cash items. The loss on disposal was \$106.2m, while the continuing businesses bore exceptional restructuring costs of US\$3.5m and a \$3.6m write-down (to nil) of the investment in Grouse.

Strong top-line growth in Betshop

Most of Betshop's 1,100-strong network of shops has been added over the last two years and this is reflected in the very strong growth in like-for-like turnover and gross win in 2006 shown in Exhibit 1, up 247% (to \$116.7m) and 187% (to \$27.4m) respectively. Betshop Italia (the shop network) contributed about 70% of this and Betshop.com most of the rest. Net win is stated before agents' revenue shares (typically 30–45%) and betting tax (8½%). With unfavourable sports results over the World Cup and in the autumn, plus an investment in infrastructure and working capital as the business grew, we guess that it probably traded at a small loss overall for the year.

2007/2008 forecasts

We have left our pre-tax and EPS forecasts unchanged from those detailed in our report of 29 November. Turnover growth is driven mainly by new shop openings, with 500 shops having opened since the acquisition last June. Sports margins should be much better than the difficult 2006/World Cup, but we are including little in our numbers for new products. We expect Betshop to contribute EBIT of \$5.9m in 2007 (slightly above its minimum earn-out target of \$5.0m), and estimate group pre-tax of \$4.5m after \$1.2m of central costs and \$0.2m of interest payable.

Betshop's 2006 results underlined the need for product and geographic diversification and the company is making good progress on these fronts. It has introduced scratchcards in Betshop Italia and will shortly launch poker on Betshop.com. The 58 new licences (15 for new premises and 43 for existing shops) will allow the introduction of additional new products such as pool betting, bingo, lottery and skill games during 2007. Betshop also plans to apply its franchise model to other countries and is in the process of rolling out a network in Romania (where it already holds a betting licence) which should begin to contribute from Q307. The franchise model is very attractive because it combines immediate local expertise with the ability to expand rapidly, without the need for significant capital outlays either for premises or marketing.

Balance sheet and cash flows

In November 2006 LNG successfully secured releases from previous earn-out obligations and refinanced the company, putting the group on a sound financial footing with \$1.2m of net cash (excluding client funds) at the year-end. The group should be cash generative in 2007, although significant new product or geographic expansion could require additional working capital.

Valuation: Peer group comparison

LNG's valuation currently appears to be well out of line with the rest of the online gaming sector. In part this reflects the broader product and geographic spreads of the larger operators, whose valuations also include some bid premium. However, it also seems that LNG has not yet participated in the rally in improved confidence towards the sector as a whole.

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

Note: * normalised, excluding share option costs and exceptional items.

** US\$ amounts converted at £1 = US\$1.94.

Company	Price (p)	Mkt Cap (£m)	Pretax* (£m)	EPS* (p)	EV/EBITDA* (x)	P/E (x)
PartyGaming **	45	1,852	51.0	1.2	26.6	37.5
888 Holdings **	118	398	15.0	4.5	23.7	26.2
Sportingbet (to Dec)	64	277	17.0	3.1	14.5	21.3
32 Red	30.5	17	0.9	1.6	2.0	19.1
Ladbrokes	408.5	2,569	205.0	25.5	16.8	16.0
Paddy Power (€)	€19.78	€1,014	€56.0	91c	14.4	21.3
Leisure & Gaming **	10.25	7	2.3	2.2	2.9	4.7

Source: Hemscott consensus forecasts/Edison Investment Research

Exhibit 3: Financials

Note: 2006 results include US-facing businesses up to the date of disposal on 13 October

Year-ending 31 December	2005	2006	2007e	2008e
Accounting basis: IFRS	16 mth			
US\$m				
PROFIT & LOSS				
Revenue	261	604	200	300
Net win	23.3	92.4	50.0	75.0
EBITDA	1.6	10.1	4.8	9.2
Operating Profit (before GW and except.)	1.4	10.0	4.7	9.0
Goodwill Amortisation	0.0	0.0	0.0	0.0
Share options	(1.2)	(0.5)	0.0	0.0
Exceptionals	0.0	(113.3)	0.0	0.0
Operating Profit	0.2	(103.8)	4.7	9.0
Net Interest	0.3	(0.5)	(0.2)	0.0
Profit Before Tax (norm)	1.7	9.5	4.5	9.0
Profit Before Tax (FRS 3)	0.5	(104.3)	4.5	9.0
Tax	(0.4)	(0.7)	(1.5)	(2.8)
Profit After Tax (norm)	1.3	8.8	3.0	6.2
Profit After Tax (FRS 3)	0.1	(105.0)	3.0	6.2
Average Number of Shares Outstanding (m)	14	63	71	77
EPS - normalised fully diluted (c)	9.6	14.0	4.2	8.1
EPS - FRS 3 (c)	9.9	(166.7)	4.2	8.1
Net win margin (%)	9%	15%	25%	25%
EBITDA Margin (%)	1%	2%	2%	3%
Operating Margin (before GW and except.) (%)	1%	2%	2%	3%
BALANCE SHEET				
Fixed Assets	112.3	41.7	41.9	42.2
Intangible Assets	110.9	41.6	41.6	41.6
Tangible Assets	1.4	0.1	0.3	0.6
Investment in associates	0.0	0.0	0.0	0.0
Current Assets	37.1	7.4	6.1	8.8
Stocks	0.0	0.0	0.0	0.0
Debtors	20.1	2.5	4.1	5.3
Cash (net of client funds)	17.0	4.9	2.0	3.5
Current Liabilities	(16.2)	(9.6)	(5.7)	(7.0)
Creditors	(16.2)	(7.2)	(5.7)	(7.0)
Short term borrowings	0.0	(2.4)	0.0	0.0
Long Term Liabilities	(17.4)	(15.6)	(14.3)	(8.0)
Long term borrowings	0.0	(1.3)	0.0	0.0
Other long term liabilities	(17.4)	(14.3)	(14.3)	(8.0)
Net Assets	115.8	23.9	28.0	36.0
CASH FLOW				
Operating Cash Flow	3.8	4.7	2.8	8.0
Net Interest	0.1	(0.3)	(0.2)	0.0
Tax	0.0	(0.4)	(1.2)	(2.0)
Capex	(1.6)	(3.9)	(0.6)	(1.0)
Acquisitions/disposals	(31.9)	(21.4)	0.0	(3.5)
Financing	46.6	5.5	0.0	0.0
Dividends	0.0	0.0	0.0	0.0
Net Cash Flow	17.0	(15.8)	0.8	1.5
Opening net debt/(cash)	0.0	(17.0)	(1.2)	(2.0)
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	0.0	0.0	0.0
Closing net debt/(cash)	(17.0)	(1.2)	(2.0)	(3.5)

Source: Leisure & Gaming/Edison Investment Research

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