June 18, 2014

OPAP - Greek Organization of Football Prognostics S.A.

A Ten-Second Pitch

OPAP is one of the biggest betting firms in Europe, located in Greece. In our opinion OPAP offers an attractive investment in a superbly profitable business that requires little capital to run and serves the heart of the Greek culture. It also offers a way to capitalize on improving Greek economy with a very large catalyst in the next twelve months, and with little to no downside. Under conservative assumptions, an investment with OPAP should produce a CAGR of 23% over the next two and a half years, which reflect a total upside of 68%. Due to the nature of the business and its de-facto monopoly, this result should be achieved in either a bull or bear market and does not, to a large extent, depend on the overall market's performance.

Executive Summary

OPAP operates 4,869 betting agencies in Greece and Cyprus. It enjoys an exclusive monopoly under state license for practically all the ex-casino and ex-track betting in Greece, and holds long-term licenses to continue and operate under these favorable terms. Sometimes, monopolies tend to be inefficient and expose the investor to regulatory risks, but OPAP's state monopoly had been recently challenged for state-aid in multiple fronts, which caused the tax regime of OPAP to change. This change removed any merit from all such claims so that now OPAP enjoys regulatory clarity. Almost all of OPAP expenses are variable, it never lost money over any period or any recession, it is highly predictable business and offers an excellent downside protection. In this write-up we survey the changes that OPAP has undergone in the last few years and show the tremendous upside potential that exists, thanks to new operators and several big projects that are being executed and can easily double OPAP's earning power. First, we review the history of the company. Then we will look at the political and the non-market landscape. Next we write about the resiliency of the business and review its operations. Following will be a zoom-out and overall look at the industry that will allow us to understand the potential of the projects that the company has embarked upon, which will be reviewed next. Finally, we explain why does the opportunity exist and why the analysts are confused, touching on the valuation and the upside under several possible scenarios. With that, let's get started.

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History

Established in 1958 as a state owned company, OPAP manages and operates betting operations across Greece, other than casinos and racetracks. In 2001, after a few structural changes it was partially privatized and listed on the Athens stock exchange. In 13.10.2000, prior to the partial privatization, OPAP was given a 20-year concession to operate all of the sport betting games and number betting games currently active in Greece. OPAP also received the exclusive right for any future sport betting games and a preemptive right for exclusive management and conduct to any other betting games the Greek government allows or monitors with the sole condition that it will start operating the game within a given deadline, which will not be longer than 4 months. Margins on these games were lucrative and were in excess of 10% on revenues in the billions. Back in 2000, this 20-year concession was valued at the ridiculously low amount of 323 million Euros. For example, during the ten-year period that ended in 2013, OPAP earned a whopping 5.5 billion Euros after all taxes under this concession. In the year 2011, OPAP negotiated a ten-year extension to the concession so now it lasts until 12.10.2030 for another relatively low payment of 375 million Euros.

Political influence and privatization

In the past, OPAP was so profitable that it was considered the "Golden Goose" of the Greek government. Changing its tax regime lately (more on that later) increased tax collection in Greece by amounts that are measured dozens of basis points of GDP. This profitability attracted politicians to meddle with the company. Since OPAP was a government controlled company, management usually changed when a new government was elected in Greece. Politicians always had a "better idea" what to do with the company than their predecessors and every politician wanted "his man" at the head of the company. Such frequent changes in management and strategy caused inefficiencies to mushroom, led to confusion, managerial mistakes and drove the company for shortsighted non-value-oriented targets.

Recently, as part of the privatization of Greek government assets, the majority government's controlling stake was sold by an auction in which numerous players participated. After the second stage, only two firms presided: Emma-Delta, The eventual winner, and Dan Loeb's Third-Point. Third Point eventually lost the bidding since it made a conditional offer. The winner, Emma-Delta, is a private equity firm that now holds 33% of the company, while the government remains a 1% holder. Under private hands, all board members were replaced and the entire management team was fired. New management is now restructuring internal structure of OPAP and OPAP already shows great improvements, surprising even the best of analysts.

Monopoly Legality and Tax Regime Change

In 2011, OPAP monopoly's legality was challenged in the EU Supreme court by some European betting companies (among them StanleyBet and William Hill), and by RGA (Remote Gambling Association). They claimed that OPAP's monopoly is illegal, considered a "state-aid" and is against the EU laws. After a prolonged heated battle, and partly as a preventative measure, in 2012 the Greek Parliament passed a new law that required OPAP and any other operator in Greece to pay from 30% up to 35% tax (depending on some milestones) on GGR (Gross Gaming Revenues – Revenues after payout to winners), the highest rate in the European Union by a wide margin. This law removed merit from the state-aid claims and turned expansion into Greece far less attractive proposition for the claiming companies. One might say that they won by burning everything down, a Pyrrhic victory. Aside from dramatically lowering the profitability of OPAP, the tax regime change actually had a few positive consequences: First, it removed the regulatory pressure from within Greece and from the EU. Second, it made entry into Greek market far less appealing for would-be competitors, even if the monopoly would someday disappear, although the risk to that is De Minimis.

The law passed in 2012 also changed how gambling winnings will be taxed. Previously, winners had to pay tax only on very high winnings of over 500 Euros. The new law taxed the winner from the first Euro at first, but after consulting with OPAP officials the framework was amended and small winnings below 100 Euros will not be taxed, a rate of 15% tax will be set on winnings from 100 to 500 Euros and 20% above 500 Euros. The reason OPAP requested this amendment is because of a term called "recycling". "Recycling" means that winners use their winnings to bet again, thus lowering final payout and "recycle" their winning. Taxation on small winnings would have hurt recycling and lower revenue. This also goes to show that OPAP has the government ear.

Resiliency

OPAP is highly resilient to macro-economic shocks and stress. Since peaking in 2008, revenues have declined from EUR 5.5B to EUR 3.7B in 2013, a 32% decline. During this period Greece was undertaken by a political and fiscal turmoil, a significant percentage of Greek businesses went bankrupt and some reports show that certain places in Greece are on the brink of a humanitarian crisis. Not only did OPAP not lose a cent, but also it continued to be meaningfully profitable as it adjusts to the new landscape. To put OPAP's resiliency into perspective, at the end of 2008 OPAP had 5,227 agencies, and after the deepest depression the country has experienced in its modern history, in 2013 OPAP had 4,869 agencies, 5 years into the greatest depression the country knew in modern times.

OPAP's resilience stems from two factors: First is the tendency of the Greek people to gamble. This tendency is strong in Mediterranean countries and it is considered part of the culture and symbolizes hope. The agencies are also a place of gathering and meeting friends, another strong habit in the Mediterranean countries. Second, practically all of OPAP's expenses are variable and it bears little to no operating risk of its vast network of agencies.

OPAP's Operations

OPAP uses a decentralized franchised operation where it licenses agents to offer its games. Agents are paid by percentage of revenue they generate and are typically mom-and-pop operations, thus minimizing operating risk and allowing for ownership mentality. It also allows a thin corporate headquarters and leaves bandwidth for management to focus on the company's strategy.

There are currently 4,869 agencies spread all across Greece. If you've been to Greece, you've probably seen an OPAP agency. In fact, agency distribution is so vast there is no other national franchise that matches OPAP's.

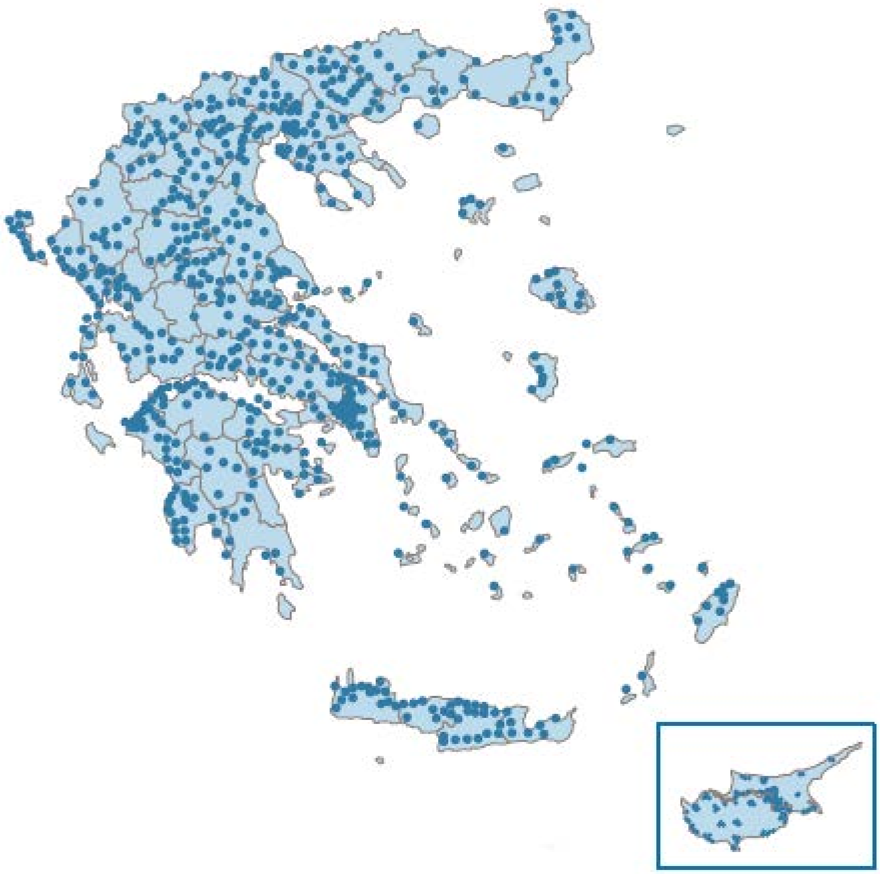

Figure 1- OPAP agency distribution (including Cyprus)

Traditionally, OPAP has operated several "land-based" games, i.e. games that players fill forms in order to participate. There are two types of games: fixed odds, and sport betting. Fixed odds games are easy to manage since the distribution of winners is statistical while sport betting risk management is more complex and is done in-house since 2007. In sport betting revenues also depend on sport events during the calendar year so one should expect a rise in a world cup period, such as Q2 2014.

Every game has a designed, pre-determined payout ratio. Payout ratio is the amount of revenue that is returned back to the gamblers in the form of winnings. The minimum payout is set in the concession from the government, but mostly the payout is higher than the minimum amount in order to attract customers. Land based games are targeting payouts of 65-67% of total revenue and electronic games will target 85% payout.

Since receiving the concession to operate land based games, OPAP introduced several new games, but the two “blockbuster” games are STIHIMA (54.4% of revenue, Fixed Odds) which was introduced in Jan 2000 and Kino (33.9% of revenue, Sports Betting) which was introduced in Oct 2004. Both games are highly recognized by the Greek people and have a very strong brand. Revenues have a slight seasonality with the fourth quarter usually having the highest revenue.

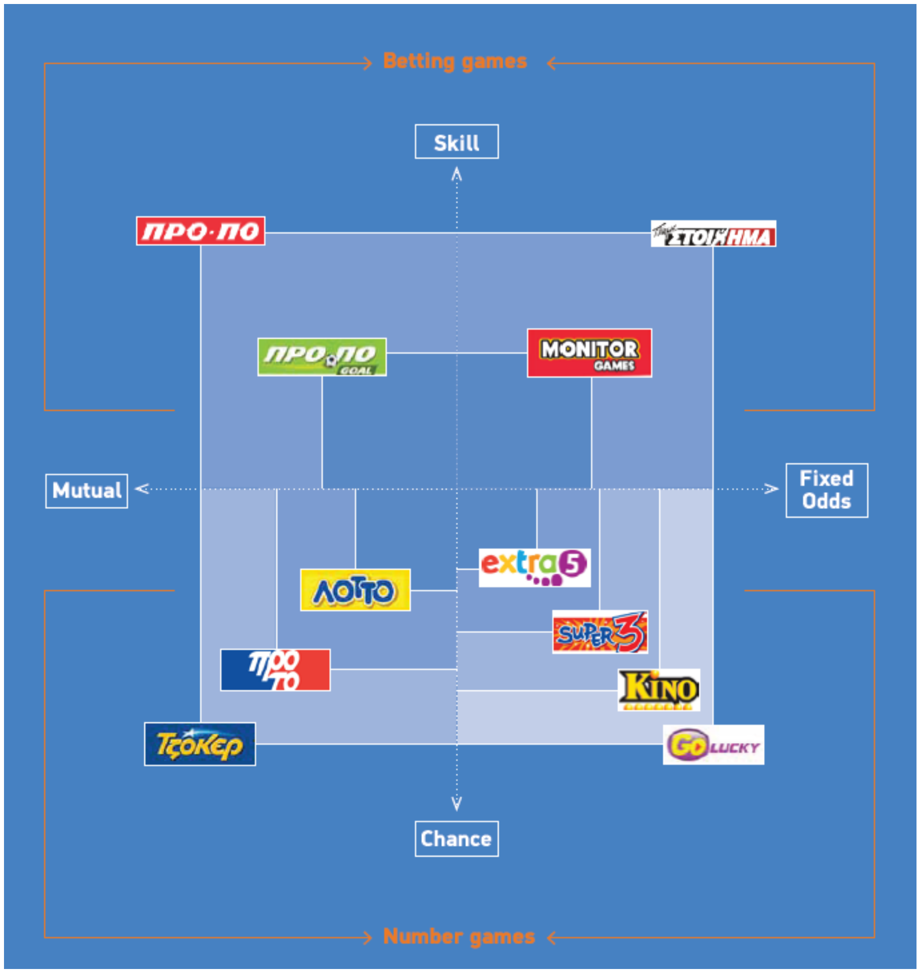

Figure 2- OPAP Games offerings

More recently, OPAP was granted an exclusive license to market its games online, it won an auction for the exclusive license for the Greek state lotteries (twelve years) and bought an exclusive license to operate 35,000 Video lotto (VLT) machines for ten years in exchange for 560 million Euros (already paid in full), the latter of which can be an enormous catalyst for the company.

Understanding the Market

The Greek betting market is divided into two main sectors: legal and illegal betting. Illegal betting has plagued the country and it is estimated that its share is more than 50% of the market revenues. Recent economic downturn has led the government to invest more in enforcement in order to reduce this phenomenon and increase tax flow. In last September the EU has outlined a more concrete enforcement against illegal gambling in member states.

The Greek betting market has suffered five long years of decline due to the debt crisis. Nevertheless, it still remains a large market with estimated legal GGR of EUR 1.5B, most of it is controlled by OPAP.

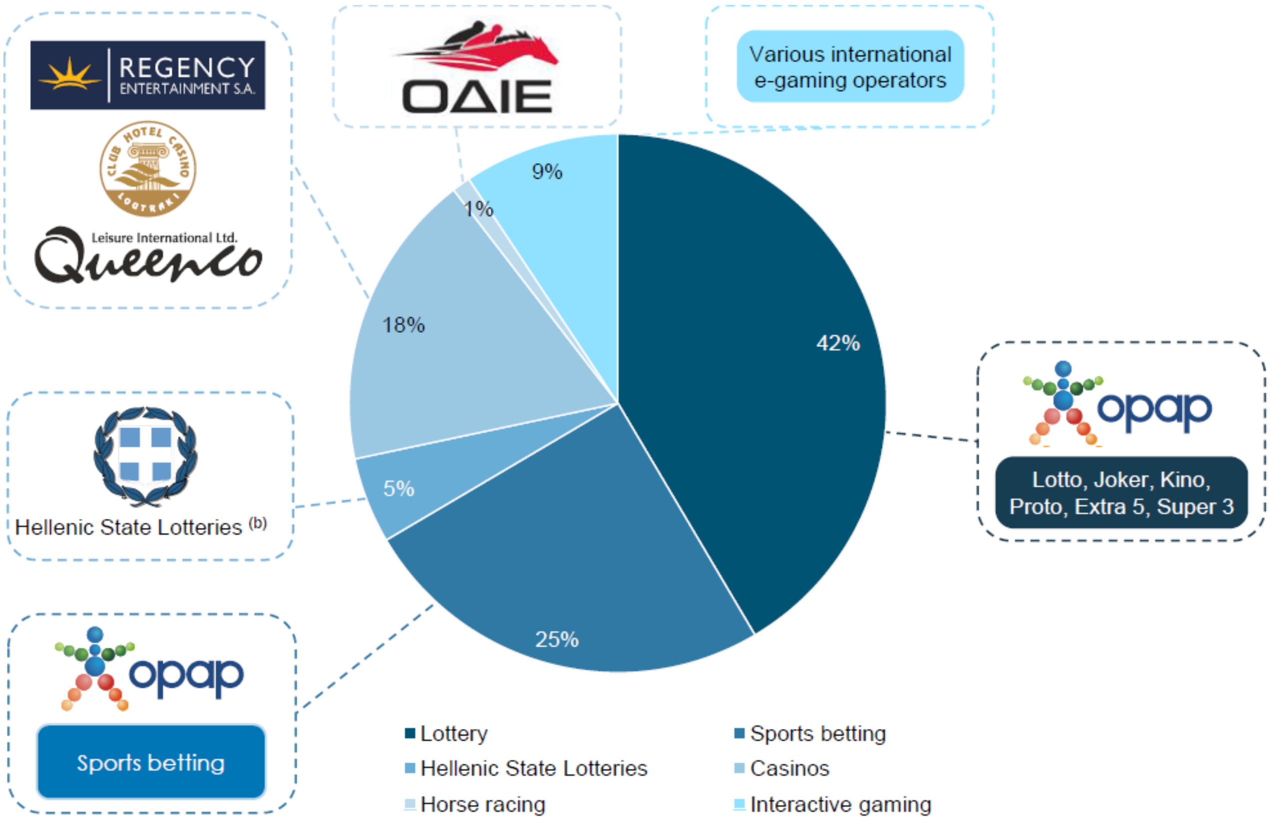

Figure 3 - Greek Legal Betting market 2012, OPAP's Share - 72%

Greek people generally gamble more than their European peers. Due to the financial crisis that caused about 40% decline in GGR and the enormous size of the illegal gaming market (we will soon find out how it will contribute to this thesis), this fact became obscure, as you can see in the chart below (Figure 4) - a look in the chart shows that as of 2012, Greek market average (legal) GGR per adult is slightly below the EU average. But if we consider illegal gambling market, Greece is located almost at the top of the list.

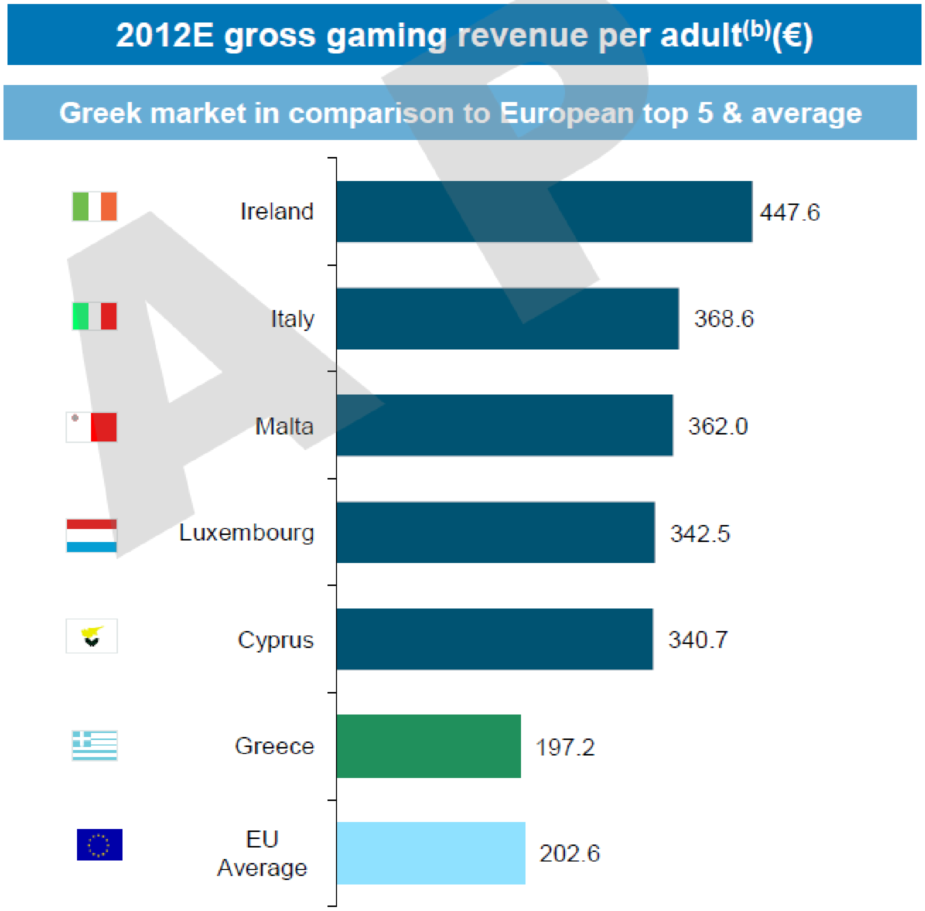

Figure 4 - Greece Legal GGR per adult in comparison to EU countries

One may ask why the Greek illegal market is so large. One of the most apparent reasons is lack of adequate enforcement, but the main reason is lack of modern gambling venues to quench the people's thirst to gamble.

In year 2002, the Italian government introduced AWP machines (Amusement with prize) into the Italian market in an effort to curb illegal gambling and increase tax revenues. Since then, hundreds of thousands of machines were installed. Competition took its course and along with enforcement, illegal gambling decreased dramatically to less than 15% of the market while legal market exploded. With that, the market as a whole increased dramatically in size.

Fast-forward 15 years to Greece, which is now exactly where Italy was in the year 2000. Currently, tens of thousands of gaming machines are operating in the illegal market in Greece. Introducing VLTs in the legal market will decrease huge illegal gaming market share, while also increasing market size. After all, there is not much sense in betting in an illegal gaming hall with all the risks attached to it when you have a legal one just down the street.

Recent developments

After 5 years of decline in revenue as a result of the crisis in Greece, recent quarters have shown not only a stop to the decline, but last quarter showed a large, surprising increase in revenue and profitability that caught analysts by surprise, prompting them to raise target prices. Revenue increased 11%, 4%, 0.7% in 14Q1, 13Q4, 13Q3 respectively, thus also increasing GGR. This was in face of a higher payout in some games and still contracting Greek economy and declining economic activity, albeit in a much slower pace.

The market missed the extent of which the operating and marketing reforms headed by the new private management will affect operational efficiency and overall gaming market response. As OPAP's CEO Kamil Ziegler put it in the latest conference call: "… and in this kind of environment, OPAP stood out as a clear outperformer."

Last year, after Third Point lost the bidding to Emma-Delta, Seth Klarman's Baupost Group took a 5% stake in the company, a stake it holds to this day. We view it as another approval of the company's great long-term potential.

Aside from the company, the Greek economy is finally showing signs of return to Growth. Budget deficit is ahead of Government expectation, tax revenue is up, budget execution in the first five months of this year showed almost a billion euros primary surplus. In 2013, Greece showed the first structural surplus since 1973. Since most of the time GGR shows good correlation with GDP, this is an important positive indication for OPAP.

VLT – Value Hidden In Plain Sight

The central block of the thesis is the VLT license, granted to OPAP in 2011 and this is the final piece before we get to the long awaited valuation part of the thesis.

First, let's have a look on Greece close neighbor – Italy. Italy followed a similar process of deploying VLT's in 2010 when **Lottomatica** introduced the first VLTs into the Italian market. The Italian market had already been introduced with AWP machines (Amusement with Prize, much simpler than VLT machines) in 2002 and as such it was not the first time Italians bet using a machine - At the end of 2010 Lottomatica alone had 56,000 AWP machines all over Italy. One would expect a moderate acceptance of the more advanced machines.

Lottomatica predicted a daily drop (daily profit) of 80 Euros per machine on revenue of 200,000 Euro per year, which translates to 85% payout (minimum payout required by law in Italy). 18 months after starting deployment and after deploying 80% of planned machines, Lottomatica was overwhelmed by the response to the VLT machines. Today, a VLT machine in Italy generates an average of 600,000 to 750,000 Euros of revenue per machine per year, a far cry from the predicted 200,000 per year.

VLT License and Execution

The license to operate 35,000 VLT machines in Greece was granted exclusively to OPAP for ten years in exchange for a payment of 560 million Euros in 2011. The ten years are counted starting from the final decision of the regulator on the machines framework (a decision expected to be made in Q4 2014). The license is divided into two parts: 16,500 machines that must be deployed in twelve months and will be operated directly by OPAP, and 18,500 machines that must be deployed in 24 months and will be operated by 3rd parties, licensed by OPAP and regulated by OPAP, with an option for OPAP to operate them directly given certain circumstances. Any machine that will not be deployed in time would be reduced from the license.

To make things interesting, OPAP recently hired an Italian national with vast experience in deploying VLTs in Italy - Mr. Giacomo Bozzini, and appointed him as Chief VLT officer. Marco Sala, Lottomatica's CEO, sits in OPAP's board of directors. VLT deployment in Greece will be done by capable, experienced hands.

The Market's Confusion

In our opinion, a few problems cause the market to misprice the company.

A 126-slide presentation by former management that was released in early 2013 showed that management estimated annual revenue per machine to be 185,000 euros. It also showed overall profit numbers which were far below market expectations. We were surprised by management's predictions and stock price crashed the same day, but these numbers were proven incorrect within the same year, after new management from Emma Delta took the steering wheel. After analysts kept harassing new management regarding data in this presentation, it even issued a press release recalling figures in the presentation, but since it was so detailed, analysts continue to rely on it relentlessly.

A quick look in common databases like Morning Star or Thompson Reuters reveal that financial numbers are incorrect for OPAP. This is quite surprising considering the size of the company, but nevertheless it can cause confusion.

In conference calls no analyst asked regarding taking market share from the illegal market by using new VLTs. We saw how illegal markets were crushed in Italy by these machines, where a large part of machine revenue growth was actually money that was spent in illegal markets and moved to legal venues. Analysts like to tie the rise of GGR to a rise in GDP, in the thought that in order to gambling to increase, consumer power should increase. Thus they conclude Greece's GDP must increase for OPAPs to see growth. But **in order for our thesis to succeed, we do not need any GDP growth or strengthening of the Greek consumer whatsoever** – just rerouting of **some** of the illegal spending to legal venues spending, as happened in Italy and other countries more than 10 years ago.

This goes to show that the market is underestimating the impact on illegal gambling and underestimating the acceptance of the new machines.

First, the Greek market has never seen a legal gambling machine thus new machines will not have any prior competition like there was in the Italian market, in which VLTs competed with existing AWP machines.

Second, if we use the GDP per capita as a remote proxy for betting per machine (used by management), Greece's GDP per capita is lower by 33% from Italy's, making the relevant revenue per machine number in the area of 400,000 Euros per machine per year, more than double previous management estimations.

Third, gaming machines density per capita will be much lower in Greece than in Italy (i.e. – more people available per machine installed).

Valuation

First, we should note that a PE firm is controlling OPAP, thus one have to understand a little on PE firms mechanics. PE companies take control of other companies, improve them and usually sell them at a higher price. PE firms improve controlled companies by a combination of three factors:

1. Operational improvements – internal structure change, operating efficiencies, divestitures, etc.
2. Recapitalization – optimizing the capital structure of the company (buying back shares, incurring debt, etc)
3. Less relevant for the thesis, but a part of PE value creation stems from multiple expansion.

Per above bullet #2, Emma Delta will probably recapitalize OPAP once all VLTs are installed, late 2016 or early 2017 or in about 2.5 years' time. Emma Delta used expensive financing due 2017 to purchase the controlling stake in OPAP, a financing they intend to repay using proceeding from recapitalization. To view earning power independently of capital structure, we should view EV / EBITDA. As of writing OPAP's market cap is around 4.2 billion Euro, EV equals to about 4 billion euro as OPAP has excess cash, TTM EBITDA was 241 million Euro and it has no debt.

We have constructed three main scenarios for OPAP up to Q4 of 2016. All of them use an assumption of recapitalization at 5 times EBITDA in 2.5 years' time, as customary for PE companies, in order to arrive to a more tax-efficient structure and increase ROE. Since Emma Delta used expensive financing to purchase its stake, recap may happen even earlier.

In the bear case we took events to the extreme, which is highly unlikely. Bear case constitutes another 30% drop in land-based games, similar to the entire drop that occurred from 2008 to 2013, in face of recent rise in revenues. Bear case also takes prior management guide number of 185,000 Euros revenue per VLT machine, an outright failure viewing other countries in Europe and considering the enormous size of the illegal market. EBITDA GGR margins on existing games will not expand and stay on 20% (currently at ~24%), payout will increase dramatically to 70% on all games. This perfect storm creates a small downside of 8% over the course of 2.5 years, not including dividends. Dividends should cover this downside entirely.

In the mid scenario land-based games stay within recent TTM levels (ignoring recent growth), payout increases to 69% (currently at 66.8%) and EBITDA margins are at 22% from GGR (currently are at almost 24%). VLT machines prove a success and annual revenue per machine is within 380,000 euros per year, a little over half that of Italy. Tax on machines GGR is maximal, as pay to agents and 3rd parties. In our opinion, this is the most probable outcome, being conservative. This yields almost 70% upside in 2.5 years, not inclusive of dividends.

In the "Italy based" scenario we used a bit more optimistic numbers. First, we assumed Land-Based games revenue will increase by 20% over the course of 2.5 years, still below current trajectory (11% increase in 2014Q1). 20% increase will correlate well with the GDP increase forecasted by World Bank for that period. Payout will increase to 68%, still above historical numbers. EBITDA margins will expand to 25% of GGR per new management under Kamil Ziegler operating efficiencies (last quarter at ~24%). VLT machines will prove as overwhelming success, similar to what happened in Italy, and produce 500,000 Euros per year per machine, but still much less than in Italy and on a far lower machine density per capita. Under this scenario, OPAP has 160% upside not inclusive of dividends.

When building these valuation scenarios, we tried to view the business from as high altitude as possible in order to be "approximately right" and not "exactly wrong". Here is a link to a Google-Docs excel document that sums up most of the facts mentioned in this write-up. A screen capture of the Excel tables is added in the appendixes for your convenience.

Conclusion

We have been following OPAP since 2011 and investing with OPAP since 2012. In our experience there is a very high probability for the mid scenario to happen. In our view, this investment has a very low downside, in a fantastic business, with very good and protected economics, controlled by an experienced management team that already had some considerable achievements and has done very good in the past. So many good things can happen to OPAP and so very few bad things can happen – odds are clearly in its favor. Greece's financial bottom provides us with even more margin of safety – We prefer investing in the correct time of the cycle, which is almost obviously it.

Appendixes

OPAP : Sum of parts

"Typical" Year - Jan 2017- Earning power	Bear	Mid	Italy based
Existing Games Revenue	2,665	3,807	4,569
GGR, 70%, 69%, 68% payout	800	1,180	1,462
Existing EBITDA, 20-25% of GGR	160	260	366
EBITDA 16500 machines	151	279	372
EBITDA 18500 machines	87	127	167
EBITDA Lottery and Scratch cards	35	42	67
EBITDA Online	-5	0	20
EBITDA TOTAL	428	708	991

* 2017 Will be the first full year in which all machines are deployed

VLT Section - Per machine	Bear	Mid	Italy based
Payout		85%	
Wagers	185,000	380,000	500,000
Net Drop/day	76.03	156.16	205.48
GGR	27,750	57,000	75,000
Net of Tax/year (30%,35%,35%)	19,425	37,050	48,750
VLT 16500			
Net of Max Agent fee @ 25%	12,488	22,800	30,000
Net of tech @ 8.7%	10,073	17,841	23,475
X 16500 [EU'm]	166	294	387
Staff & Central	15	15	15
EBITDA	151	279	372
VLT 18500			
Net of max Agent and 3rd party @ 53%	4,717.50	6,840.00	9,000.00
X 18500 [EU'm]	87	127	167
EBITDA	87	127	167

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OPAP: Bear Scenario

Today (MM Euro)			
EBITDA	241	TTM	
Share price as of wrting	13.17		
Equity Value	4201.23		
EV	4033.23	(168 MM in cash)	
EV/EBITDA	16.74		
Recap in 2.5 years (MM Euro)			
EBITDA	428	Base scenario, no growth after second year	
Take Debt	2,142	At least 5 times EBITDA, per PE companies	
Recap payout as dividend	2,142		
EV/EBITDA	9		
Equity Value	1,714		
Upside	**-8.23%**	Not inclusive of dividends	
CAGR	**-3.38%**	Not inclusive of dividends	
Sanity Check - Regular P/E (MM Euro)			
EBITDA	428		
Intereset	150	6% on its debt	2.857142857 Coverage ratio
Depreciation	140	Real expense as licenses need to be renewed eventually	
Pretax	138		
Tax	36	26% corporate tax in Greece	
NI	102		
Resulting P/E	16.72	Lower than peers in Europe	

IRR			
	2014	**2015**	**2016**
CF	-4201	2142	1714
	Investement	Dividend payout	Equity value
IRR	**-6%**	Not inclusive of dividends	

OPAP: Mid Scenario

Today (MM Euro)				
EBITDA	241	TTM		
Share price as of wrting	13.17			
Equity Value	4201.23	MM Euro		
EV	4033.23	MM Euro		
EV/EBITDA	16.74			
Recap in 2.5 years (MM Euro)				
EBITDA	708	Base scenario, no growth after second year		
Take Debt	3,538	At least 5 times EBITDA, per PE companies		
Recap payout as dividend	3,538			
EV/EBITDA	10			
Equity Value	3,538			
Upside	**68.42%**	Not inclusive of dividends		
CAGR	**23.19%**	Not inclusive of dividends		
Sanity Check - Regular P/E (MM Euro)				
EBITDA	708			
Intereset	248	7% on its debt	2.857142857	Coverage Ratio
Depreciation	140	Real expense as licenses need to be renewed eventually		
Pretax	320			
Tax	83	26% corporate tax in Greece		
NI	237			
Resulting P/E	14.94	Lower than peers in Europe		

IRR			
	2014	**2015**	**2016**
CF	-4201	3538	3538
	Investement	Dividend payout	Equity value
IRR	**43%**	Not inclusive of dividends	

OPAP: Italy Based Scenario

Today (MM Euro)					IRR			
EBITDA	241	TTM				**2014**	**2015**	**2016**
Share price as of wrting	13.17				CF	-4201	4957	5948
Equity Value	4201.23	MM Euro				Investement	Dividend payout	Equity value
EV	4033.23	MM Euro			**IRR**	**92%**	Not inclusive of dividends	
EV/EBITDA	16.74							
Recap in 2.5 years (MM Euro)								
EBITDA	991	Base scenario, no growth after second year						
Take Debt	4,957	At least 5 times EBITDA, per PE companies						
Recap payout as dividend	4,957							
EV/EBITDA	11							
Equity Value	5,948							
Upside	**159.57%**	Not inclusive of dividends						
CAGR	**46.45%**	Not inclusive of dividends						
Sanity Check - Regular P/E (MM Euro)								
EBITDA	991							
Intereset	347	7% on its debt	2.857142857	Coverage ratio				
Depreciation	140	Real expense as licenses need to be renewed eventually						
Pretax	504							
Tax	131	26% corporate tax in Greece						
NI	373							
Resulting P/E	15.94	Lower than peers in Europe						