

Probability

UK | Gambling | PBTY.L | PBTY LN

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Calling mobile right

Proving a new market

Yr to Mar £m	2007A	2008A	2009E	2010E	2011E
Sales	1.3	3.2	6.0	8.0	9.1
adj. PBT	-2.3	-1.0	0.8	1.6	2.0
adj. EPS (p)	-12.9	-5.2	3.6	7.1	9.1
EV/EBITDA (x)	n.a.	n.a.	9.3	3.7	1.9
P/E (x)	n.a.	n.a.	13.6	6.9	5.5
Div. Yld (%)	0.0	0.0	0.0	0.0	0.0

Recommendation **BUY**

Price **50p**
Target **110p**

Market Cap: £11m
EV: £7m
Shares issued: 22m
Daily ave. volume: <1m

■ Top-line momentum

Probability achieved Q-on-Q growth of 25% during YEMar2008A, albeit from a low base. Fundamental growth drivers are getting stronger: Probability now has a practically waterfront presence on the network operators' portals; mobile advertising inventory is increasing rapidly, facilitating marketing; and, an attractive series of white-label deals (eg, Sun and Rank Group) have been signed. There are now 18m people accessing mobile internet in the UK, meaning it is capable of becoming a mainstream distribution channel. Moreover, Probability's existing database of over 300,000 accounts is from a broader demographic than typical online or terrestrial punters. Consequently, we see Probability's growth profile as largely one of supply and distribution resource management, rather than proving demand.

■ Operating and capital costs

Due to the nascence and complexity of the channel, as well as limited competition, Probability currently achieves highly attractive returns on distribution expenses (27% revenue in 2008A, forecast to rise to 36% by 2011E). Administrative expenses are largely staff related and therefore highly scalable. Platform infrastructure work is now complete, meaning that cap-ex is minimal. Both revenue and costs are substantially all in sterling.

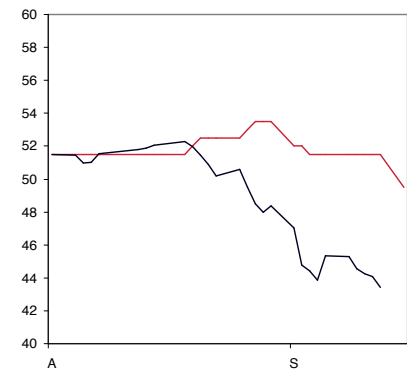
■ Upgrade/downgrade potential

We see Probability as on the cusp of delivering significant growth in the mobile gambling market. The business is now profitable and has cash reserves of c. £3m. Further marketing and product investment is therefore relatively easily funded, which should drive material medium-term upgrades.

■ Reason for recommendation

Probability is perceived as an unproven operator in a niche market. Given that the company is now profitable, revenue is gaining momentum and the market remains highly attractive from a competitive standpoint, we believe that this can change rapidly. Probability is currently trading on a forward EV/EBITDA of 3.7x in an increasingly attractive sub-sector.

Stock Performance



— Probability — FTSE AIM (Rebased)

Performance	1m	3m	12m
Absolute %	-4	0	0
Relative* %	15	0	0

Source: Datastream

*Rel to FTSE AIM

Cyclicality

We believe that mobile gambling is too small and too new to respond meaningfully to macro pressures. However, there are many aspects to the mobile product that point to relative resilience:

- The mobile device is ubiquitous and convenience-led, driving both penetration potential and 'snacking' behaviour
- Probably the closest product in terms of demographic and availability is scratch-cards, which tend to be highly defensive in a downturn
- Probability has already identified they can reach a broad demographic, increasing marketing flexibility to mitigate macro issues (until maturity)
- Current product tends to be casino and slots-led, both of which tend to be resilient

Consequently, we do not see macro-economic conditions as a significant factor in our Probability investment case.

Operations management

Probability runs a very tight organisation. Fewer than twenty developers, marketers and administrative staff are responsible for the platform. All development, payment management and marketing occurs in-house, in the UK. The operation is licensed in Alderney, while an FSA e-money registration allows flexible payment methods specific to the mobile (such as billing deposits onto the mobile bill – unique to Probability as far as we know and very useful for initial transactions). Another critical reason for Probability's success is the ability to support over 3,000 handsets and, just as importantly, to add new handsets to the system as soon as they become available (at the rate of c.4 new models per day, creating a significant barrier to success, even for mobile specialists).

Content is also developed in-house, since the size and operating dynamics of the mobile phone do not suit a direct replica of the internet model. Again, getting this right has been a key reason for Probability's success in an environment where very few operators have delivered on big promises.

The current revenue model (and our forecasts) is largely driven by direct marketing of Probability's 'Lady Luck's' brand. The paucity of other functioning mobile offers has made marketing this an attractive return on investment and we see this continuing as a long-term growth driver. From an operations management perspective, increasing work is being done to optimise marketing and customer retention through real-time analytical capabilities, which should serve to cement Probability's lead in the mobile gambling sub-sector.

Equally compellingly from a long-term strategic standpoint, a number of operators have recognised mobile is not a core competency and have white-labelled with Probability. We believe that this is a very useful call-option on market development: it is probably still too early to say whether infrastructure or marketing/customer ownership will be the most powerful part of the mobile gambling value chain, so Probability does both. As well as providing operational flexibility, we believe that this makes Probability more attractive from an M&A perspective: it could sit as the mobile arm of an operator, or of a software and services provider. It should also allow a partnership model to be adopted for new jurisdictions, if that is the most appropriate route to entry and regulations allow. Having the software capabilities to do both early also solves a lot of headaches from an operations management perspective: eg, we are sceptical of PartyGaming's ability rapidly to 'modularise' in order to participate in the online software services model, despite this now being a stated strategic goal.

Table 31: Profit and Loss Data

	2006A	2007A	2008A	2009E	2010E	2011E
Sales	0.7	1.3	3.2	6.0	8.0	9.1
EBITDA	-0.7	-2.3	-1.1	0.8	1.5	1.9
EBITA	-0.7	-2.3	-1.1	0.7	1.5	1.8
Operating Profit/ EBIT	-0.7	-2.4	-1.1	0.7	1.5	1.8
Associates & Other	0.0	0.0	0.0	0.0	0.0	0.0
Exceptionals/ Restructuring	0.0	-1.6	-0.1	0.0	0.0	0.0
Net Interest/ Financials	0.0	0.1	0.1	0.1	0.1	0.2
Pre-Tax Profit	-0.7	-3.9	-1.1	0.8	1.6	2.0
Adjusted Pre-Tax Profit	-0.7	-2.3	-1.0	0.8	1.6	2.0
Underlying Tax Rate	0.0%	8.4%	0.0%	0.0%	0.0%	0.0%
Actual P&L tax charge	0.0	0.2	0.0	0.0	0.0	0.0
Minorities	0.0	0.0	0.0	0.0	0.0	0.0
Discontinued/ Other	0.0	0.0	0.0	0.0	0.0	0.0
Net Income/ Earnings	-0.7	-3.7	-1.1	0.8	1.6	2.0
Adjusted Earnings	-0.7	-3.7	-1.1	0.8	1.6	2.0
Adjusted Diluted Earnings	-0.7	-3.5	-1.0	0.8	1.5	2.0

Source: Collins Stewart Research

Table 32: Share Data (m)

	2006A	2007A	2008A	2009E	2010E	2011E
Weighted Average Shares	11.2	15.7	18.5	21.5	21.5	21.5
Year End Shares	11.2	15.7	21.5	21.5	21.5	21.5
Diluted Shares (yr end)	11.8	16.5	19.5	22.6	22.6	22.6

Source: Collins Stewart Research

Table 33: Per Share Ratios

	2006A	2007A	2008A	2009E	2010E	2011E
Stated Earnings per Share	-6.6	-23.6	-5.8	3.8	7.5	9.5
Adjusted EPS	-6.3	-12.9	-5.2	3.6	7.1	9.1
Adj & Diluted EPS	-6.25	-12.95	-5.16	3.63	7.14	9.06
Dividends Per Share	0.00	0.00	0.00	0.00	0.00	0.00
NAV Per Share	4.95	12.47	11.04	13.14	20.28	29.33

Source: Collins Stewart Research

Table 34: Cash Flow Data

	2006A	2007A	2008A	2009E	2010E	2011E
Operating Profit/ EBIT	-0.7	-2.4	-1.1	0.7	1.5	1.8
Working Capital Change	0.1	-0.2	-0.1	0.0	0.0	0.0
Depreciation	0.0	0.0	0.0	0.1	0.1	0.1
Amortisation	0.0	0.0	0.0	0.0	0.0	0.0
Other Operating Cash Items	0.0	0.0	0.2	0.0	0.0	0.0
Operating Cashflow	-0.6	-2.5	-0.9	0.8	1.6	1.9
Tax	0.0	0.0	0.0	0.0	0.0	0.0
Net Capex	-0.1	-0.3	0.0	-0.1	-0.1	-0.1
Enterprise Free Cashflow	-0.7	-2.5	-0.9	0.8	1.6	1.9
Interest Costs	0.0	0.1	0.1	0.1	0.1	0.2
Equity Free Cashflow	-0.7	-2.7	-0.9	0.7	1.5	1.8
Dividends	0.0	0.0	0.0	0.0	0.0	0.0
Share Issuance	1.2	3.6	1.7	0.0	0.0	0.0
Acquisitions/ Disposals	0.0	0.0	0.0	0.0	0.0	0.0
Other Cash Items	0.0	0.0	0.0	0.0	0.1	0.1
Change in Net Debt	0.5	1.1	0.8	0.8	1.6	2.0

Source: Collins Stewart Research

Table 35: Balance Sheet Data

	2006A	2007A	2008A	2009E	2010E	2011E
Net Debt/ (Cash)	-0.6	-1.7	-2.5	-3.4	-5.0	-7.0
Shareholders' Funds	0.6	1.9	2.4	3.0	4.6	6.7

Source: Collins Stewart Research