

REXLot Holdings – Lottery Giant Priced Cheaply With Significant Potential In Riding Growing e-Lottery Market

Rating: Buy (44.6% upside) Share Price: HK\$0.65 Target Price: HK\$0.94

Executive Summary

We initiate a **Buy** call of an upside of **44.6%** for REXLot Holdings (REXLot), based on a PE of 10x and forward EPS of HK\$0.094. Its current PE of 6.1x is cheap for a company with market leader status poised to enjoy significant industry growth. The key catalysts for the company to reach the initiated target price includes **1) Shift in revenue mix to high growth segments “Internet” and “Mobile electronic lottery platform”, 2) High mobile internet and smart phone penetration rate to boost online lottery sales, 3) Industry tailwinds set in motion by the government to curb illegal gambling market, 4) Consistent and superior margins accompanied by a robust balance sheet.**

Growth segments buffer slowing major contributor while displaying huge growth. REXLot has seen revenue contribution from its “Internet” segment grow at a CAGR of 433% between FY11-FY13. This segment is also becoming larger gradually in terms of overall revenue (**FY10: Nil, FY13: 19.7%**). Mobile electronic lottery platform’s revenue also grew 459% between FY12 and FY13, and has gone from less than 2% of contribution to its revenue pie to commanding an 8.8% revenue contribution in REXLot’s overall revenue. Together, these 2 segments are helping to shift the revenue reliance on a slowing major contributor to those packed with significant high growth potential.

Penetration rate of mobile internet and smart phone to lift online lottery sales. The number of internet users in China has grown from 210m to 618m between 2007 – 2013; where approximately 81% are mobile internet subscribers. China’s online lottery sales have been estimated to grow at a 41% CAGR from 2012 – 2015 to RMB41.3bn. We believe this is only the start and will see further uptick when more people use their smart phones for lottery tickets purchasing.

Industry tailwinds encouraged by government. The illegal betting market is estimated to be 2 – 3 times bigger than that of the official channels. As proceeds from lottery sales are a direct source of social welfare funding, the government is incentivized to funnel the patrons from the illegal betting market to that of the legal ones.

Consistent and superior margins, strong balance sheet. REXLot has maintained consistency in terms of proving sustainable profitability. Gross profit margins (GPM) and net profit margins (NPM) are high (GPM: 72.1%; NPM: 40.1%) and have exhibited a CAGR growth of (GP: 13%, NP: 26.6%) over FY08 – FY13. ROE and ROA has also constantly been between above 12% to close to 15%, with a net cash position on the balance sheet.

Financial Highlights

Financial Year End: 31-Dec	FY12	FY13	FY14E	FY15E	FY16E
Revenue (HK\$ m)	1,962	2,165	2507	2836	3148
EBIT (HK\$ m)	959	1085	1278	1358	1541
Net Profit (HK\$ m)	867	926	956	1022	1179
EPS (HK\$ /share)	0.097	0.1	0.094	0.100	0.119
Revenue YoY %	12.8%	10.3%	15.8%	11.0%	12.0%
EBIT YoY %	16.8%	13.1%	15.9%	6%	14.5%
EPS YoY %	7.8%	2.3%	-5.6%	6.6%	19.4%
EBIT Margin (%)	48.9%	50.1%	50.1%	47.9%	49.0%
Net Profit Margin (%)	44.2%	42.8%	37.4%	35.9%	37.4%
Net Gearing (%)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash
P/E (x)	6.7	6.5	6.9	6.5	5.4
P/B (x)	1	0.9	0.9	0.8	0.8
EV/EBITDA	5.2	4.8	4	3.5	2.8
Dividend Yield (%)	2.6%	5.4%	5.8%	6.9%	9.2%

Company Name: REXLot Holdings
Bbg Ticker: HK: 0555

Share Price: HK\$0.65
Target Price: HK\$0.94
(44.6% upside)

Rating: Buy

Market Cap (HK\$/US\$):
6,474m/809.8m

Avg 1 mth daily value
traded (HK\$m/day):
20.2m

Shares outstand: 9,960m
Freefloat: 8,466m (85%)
Major shareholder 1:
Victor Chan: 15%



By: Louis

Company overview

REXLot is a leading player in the China lottery market stream with a comprehensive value chain that encompasses the upstream and downstream segments. This includes Welfare Computer Ticket Games (CTG) and Sport CTG/Single match games (SMG) terminal and systems, Scratch Card printing and validation, internet lottery platform, mobile SMS and electronic lottery platform, and also SMG stores and call center.

Internet platform becomes substantial revenue generator. REXLot currently owns 66.6% of Okooo.com, a major online lottery distribution platform in China. Okooo.com is estimated to command around 12% – 15% market share in the whole online lottery market. According to traffic statistics of Alexa, Okooo.com is one of the top 3 most popular specialized lottery platforms in China. This segment has seen revenue CAGR of some 433% between FY11 – FY13. In terms of percentage of contribution to sales, REXLot's revenue contribution from the internet platform stood at 0.8% in FY11, and has grown to an astounding 19.7% in FY13.

	FY11	FY12	FY13
Welfare CTG	37.4%	33%	37.6%
Scratch Card Distribution	21.1%	20.2%	15.1%
Internet Platform	0.8%	16.2%	19.7%
Mobile ELP	NIL	1.7%	8.8%
Mobil SMS Platform	14.7%	12.5%	6.5%
Others	25.8%	16.4%	12.3%

Revenue contribution of REXLot's segments (Source: Company)

Expect growth muscle from Internet platform to strengthen. Okooo.com has a well-established cooperation relationship with the provincial centers, which cannot be easily replicated. REXLot has a robust system that allows the placement of an online lottery order to the corresponding provincial lottery pools based on the origin of the buyers. Lottery orders from portal websites like Taobao caipiao, the doesn't have such vertically integrated placement system will need to go through Okooo.com to have their orders placed, in which Okooo.com charges a 3 – 5% distribution fee. According to iResearch, internet lottery sales in China are expected to grow at a 41.3% CAGR in the next three years to RMB41.3bn, we think Okooo.com will benefit largely and grow in line with the industry.

High likelihood of being approved by Ministry of Finance. To regulate the industry, licenses to be an approved internet lottery platform operator will soon be the bane to squeeze out other non-approved players. Given the demonstrated abilities of Okooo.com in terms of reputation among internet lottery users, technological capability, and established relationships with provincial lottery centers, Okooo.com is likely to become an authorized operator in time to come. The joint venture partnership Okooo.com has with PEOPLE.CN (state owned) also puts it in a sweet spot to be favorably considered for the license to become a Ministry of Finance (MOF) – authorized operator. We believe the obtainment of such license will further propel the already growing segment into new trajectory.

Mobile electronic lottery platform seeing traction, expected to pack further punch. REXLot was the first approved mobile electronic lottery platform (ELP) developer in the PRC. The 2012 pilot test in Liaoning saw the start of commercial operations in July 2012. On the back of the successful roll out, REXLot bagged contract wins in 2 more provinces in 2H13. REXLot currently has a total coverage of 9 provinces for its mobile ELP. The possibility of REXLot working with more provinces is also high, as it has the backend system to match the orders to the corresponding provincial pools. This is difficult to replicate among its peers due to the need to have an established and reliable network.

Upon commercialization in FY12, this segment has leapfrogged by more than 458% in just one year, suggesting the beginning of a high growth phase segment. Revenue of this segment in FY12 stood at 1.7%, and at end FY13, this number has gone up to 8.8%. As operations have commenced in 1H14 for the 2 new provinces, overall contribution from this segment is expected to be raised further.

Market leader position in its Welfare CTG business segment. REXLot currently holds more than 50% of market share in the provision of CTG systems in China. It is the exclusive CTG system provider to 17 out of 32 provinces in China. This segment has been the major contributor to REXLot (FY13 : 37.6% revenue) for more than 5 years and commands a superior EBITDA margin range between 70% - 80%. As a testament to its established track record and its product quality, REXLot successfully renewed the contract services with all 13 provinces in 2006, prior to the securing of 4 more in 2007.

CTG still cash cow of REXLot. All the contracts were for a term of 5 years. The recent negotiations REXLot have with the provinces are likely to pass, where all existing 17 provincial contracts that will be up between 2015 – 2018 will be renewed for 7 years instead of the previous 5 year term. However, the recontract will be based on a lesser service rate to REXLot (0.65% - 0.85% vs 1%). Albeit the lower contribution expected we do not see this as a major headwind even though CTG commands a huge pie of REXLot's overall revenue. We expect the combined contribution and growth from the mobile ELP and Internet platform segments (28.5% combined) to buffer and overtake this business segment moving forward, while CTG provides stable cash flow support for the group.

Lottery Landscape Packed With Superior Growth Potential

Lottery sales, a fund raising mechanism by the government. There are currently only 2 regulated lottery providers in China; China Welfare Lottery Issuance and Administration Centre (CWLC) and China Sports Lottery (CSL). China's lottery wins typically pays out between 50% - 69% of its gross sales, where approximately 20% – 35% goes to the government for purposes such as social welfare and sports development purposes. *(See Appendix 1)*

Curbing illegal lotto betting. The government has been stepping up its pace to enhance regulations to tackle illegal lottery sales. According to estimates by Peking University, the illegal gambling market in China is still 2 – 3 times larger than that of the official channels. There is an incentive to drip the proceeds from the illegal market to the official ones as the proceeds are essentially used for social welfare purposes for the state. The government is in turn introducing higher payouts for lottery channels to further fuel interest in the regulated channels. The lottery market has seen exceptional CAGR growth of 24% to RMB309bn from 2000 – 2013. It is expected that the growth will continue and achieve a 20% CAGR over the next 3 years, and outpace the US to be the biggest lottery market in the world.

High correlation between consumer wealth and lottery sales. According to China's Ministry of Finance, the annual urban disposable income has quadrupled between 2000 – 2013. This essentially brings forth higher consumer wealth, which has a high correlation to lottery sales. Albeit not expecting a double digit growth in Chinese disposable income moving forward due to China's softer growth outlook, a high single digit growth in disposable income is not unreasonable to be expected. With the higher payout policies and newer games slated to be pushed out by the government, we believe lottery sales should continue to grow alongside the rising income brackets.

Online lottery sales to surge due to internet and smart-phone penetration. The rampant development of mobile and internet network have seen China growing towards becoming the largest mobile and internet bases in the world. China Internet Network Information Centre (CNNIC) revealed that the number of internet users in China have grown from 210m to 618m between 2007 – 2013. Mobile internet subscribers made up of only 24% of internet users in 2007, but have grown exponentially to 81% of total internet users in China in 2013. Although currently online lottery sales consists less than 10% of total lottery sales, iResearch estimates online lottery sales to grow at a 41.3% CAGR in the next 3 years to RMB41.3bn.

Standing out from its peers

Most comprehensive value chain among peers. REXLot is the only player that has comprehensive grounding in both the upstream and downstream parts of the lottery value chain. Among its peers, it is apparent that REXLot has a solid coverage of the downstream value chain *(See Appendix 2)*, in which significant performances from the Internet and mobile ELP platform has already been seen as a result of the popularity and penetration rate of Okooo.com, as mentioned above. The significant market share in the upstream CTG segment (>50%) also puts revenue contribution from this segment ahead of its peers. The likelihood of the re-contract of this segment for the next 7 years also dilutes the strength of REXLot's competition even further.

First mover advantage in Mobile ELP, cross selling abilities compared to peers. Although the Mobile ELP land space is expected to be competitive, REXLot was the first provider that successfully rolled out commercial operations in this segment in 2012 and currently has a presence in 9 provinces. Its established first mover advantage and track records from the successful rollout of operations in Liaoning would make it likely for REXLot to take on contracts from other provinces. REXLot's ability to also process orders and match it to the provincial pool (a rarity among its peers apart from US listed 500.com), enables it to cross bundle games from its CTG and scratch card segments and offer it in the mobile ELP space. Topping that with the expected increase in new game offerings from the provincial lottery centers, REXLot would have a wider selection of games, which would be key to attracting and keeping recurring users.

Lowest PE among peers, top operating margin. Comparing REXLot to its peers, its trailing PE of 6.1x and forward PE of 6.9x are both significantly below its peers. Both PEs are also below the peers' average, suggesting a possible discount in REXLot's share price. REXLot's

operational strength can also be seen, as it reflects the highest operating margin of 50.4% among all its peers. Net profit margin is only less than 1% away from 500.com, making REXLot the 2nd best performer in terms of net profit margin, followed by 500.com.

Company	Share Price (HK\$)	Mkt Cap (HK\$b)	Trailing P/E	Fwd P/E	P/B	D/E	EV/EBITDA	Net profit margin	Operating Margin	ROE	ROA
REXLot	HK\$0.65	6.5	6.1	6.9	0.8	0.2%	7.9	40.1%	50.4%	15.6%	11.9%
China LotSynergy	HK\$0.59	5	49.6	29.5	3.8	-3.7%	9	11.9%	47.7%	7.8%	4%
V1 Group (VOdone)	HK\$0.59	1.9	N.A	N.A	0.6	-22.5%	N.A	-26.9%	-32%	-5.8%	-4.8%
AGTech	HK\$0.87	3.9	N.A	N.A.	N.A	-23.2%	N.A	-39.8%	-13.2%	-7.2%	-6.7%
China Vanguard	HK\$1.17	3.7	143.6	N.A.	N.A.	-20.9%	107.2	15.5%	22.3%	8.7%	4.7%

Hongkong listed peers of REXLot

Company	Share Price (US\$)	Mkt Cap (US\$)	Trailing P/E	Fwd P/E	P/B	D/E	EV/EBITDA	Net profit margin	Operating Margin	ROE	ROA
500.com	\$17.80	621	NIL	14.9	0.8	0.2%	13.9	40.7%	16.4%	25.9%	15.8%

US listed peer, but operates in China

Average **66.4** **17.1** **1.5** **34.5**

Valuation

REXLot's 5 year historical PE ranges from 4.1x – 28.9x. The current PE of 6.1x puts REXLot near its lower end of the range. With a conservative growth of 10% affixed to the CTG business, coupled with correspondingly high growth rates for its Internet and mobile ELP segments (50% 60%), this would derive a forward EPS of HK\$0.094.

Using a 10x PE that is still on the lower spectrum of the historical range, this would suggest a target price of HK\$0.94, representing an upside of 44.6%.

A base case scenario would be if the CTG segment grows at a slower rate of 6% instead, and that the Internet and Mobile ELP segments grow at a slower pace of 30% each. This would derive a forward EPS of HK\$0.086. Affixing a lower PE of 6x on the EPS of \$0.086 would derive target price of HK\$0.516, representing a downside of 20.6%.

Risks to the valuation

Re-contract of CTG contracts at lower distribution rate. Continued cuts in distribution revenue REXLot's welfare CTG segment can get, in view of the next contract renewal is a concern that could impact potential revenue stream and bottom line. As this segment has seen distribution revenue cuts from 2% to the current 1%, and 0.65% – 0.85% should the recontract goes through, it is likely that further depression could be experienced in the rates should the Chinese government choose to further increase payout ratios to spur the lottery's market growth. That said, a corresponding increase from volumes of purchase due to the higher payout rates should effectively buffer off this reduced distribution.

Risk of non-approval from MOF. As the internet lottery segment is going to be the main growth driver of REXLot, and it is still in the midst of attaining the license from MOF as one of the authorized approved operators, failure to get this might see a potential shut down in the segment, should laws be enforced by MOF. Top and bottom line are at risk of being severely impacted as this would be the key primary driver of REXLot in the next 5 years. However, judging from how it was unaffected during the investigation in 2012 by the MOF to shut down unauthorized internet lottery sales service providers, we think the possibility of not being approved, is likely to be low. Also, the 60 : 40 joint venture Okoo.com has with People.cn (government background) should also help to get the approval.

Acquisitions using issuance of convertible bonds could dilute EPS. REXLot has chosen to issue convertible bonds to fund its acquisitions over the past few years. We feel that should REXLot continue acquiring more companies to strengthen or further extend its reach in its value chain and continue using convertible bonds as a form of fund raising, this is likely to have a dilution impact on its EPS.

Financial year end: 31-Dec; Source: Company

Income Statement (HK\$m)	FY12	FY13	FY14E	FY15E	FY16E
Revenue	1962	2165	2507	2783	3117
Gross Profit	1378	1583	1830	1948	2182
EBITDA	1092	1191	1407	1496	1710
EBIT	959	1085	1257	1333	1526
Interest expenses	-53	-102	-222	-222	-222
Associate Income	14	6	6	6	6
Profit Before tax	920	1000	1041	1116	1310
Tax expense	-53	-74	-104	-117	-144
Minority income/Preferred dividend	-46	-57	-64	-69	-55
Net Profit	867	926	937	999	1166

Balance Sheet 1 (HK\$m)	FY12	FY13	FY14E	FY15E	FY16E
Cash	897	1146	2593	3021	3505
Receivables	988	1115	1195	1311	1452
Inventories	133	151	165	206	233
Other current asset	835	947	947	947	947
Total – Current asset	3776	4432	5954	6540	7191
Net PPE	213	186	274	316	362
Goodwill/Intangible	2565	2519	2504	2382	2245
Associate/JV	376	388	394	400	406
Other long term asset	80	70	70	70	70
Total – Long term asset	3234	3163	3242	3168	3084
Total - Asset	7010	7595	9196	9708	10275

Balance Sheet 2 (HK\$m)	FY12	FY13	FY14E	FY15E	FY16E
Short term borrowing	62	71	71	71	71
Account Payable	47	23	41	53	61
Other short term liability	25	35	35	35	35
Total – Short term liability	257	300	318	330	338
Long term borrowing	0	0	0	0	0
Other – Long term liability	58	91	91	91	91
Convertible bonds	796	834	1900	1900	1900
Deferred tax liabilities	101	148	148	148	148
Total – Long term liability	58	91	91	91	91
Total - Liability	1212	1373	2457	2469	2477
Shareholder equity	5570	5964	6488	7000	7555
Minority interest	228	257	252	240	242
Total – Liability and Equity	7010	7595	9196	9708	10275

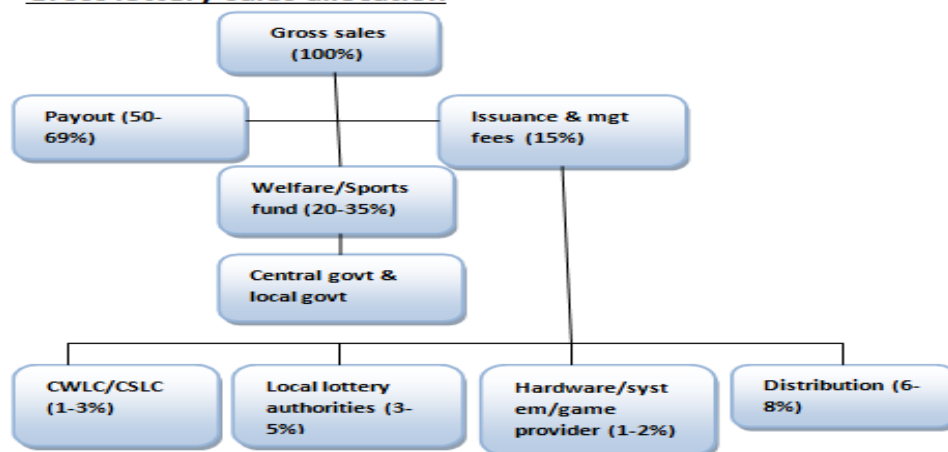
Cash Flow (HK\$m)	FY12	FY13	FY14E	FY15E	FY16E
EBIT	959	1085	1257	1333	1526
D&A	133	106	149	163	184
Net Interest expense	-51	-99	-217	-216	-215
Change in working capital	-342	-221	-76	-145	-159
Tax paid	-47	-30	-104	-117	-144
Other item	-386	-448	-448	-448	-448
Cashflow from Operation	368	591	989	995	1169
Capex	-53	-34	-50	-83	-94
Investment in JV/Associate	-14	-7	-6	-6	-6
Other investment	1	10	10	10	10
Cashflow from Investment	-263	-411	-40	-73	-84
Net debt raised	2	7	0	0	0
Equity raised	58	133	0	0	0
Dividend payout	-143	-149	-349	-419	-555

Bond issuance	460	0	790	0	0
Other financing cash flow	-33	57	57	57	57
Cashflow from Financing	344	48	498	-494	-601
FX impact	5	22	0	0	0
Beginning cash	442	896	1146	2593	3021
Ending cash	896	1146	2593	3021	3505

Ratios	FY12	FY13	FY14E	FY15E	FY16E
Revenue YoY %	12.8%	10.3%	15.8%	11.0%	12.0%
EBIT YoY %	16.8%	13.1%	15.9%	6%	14.5%
Net Profit YoY %	12.9%	6.8%	1.2%	6.6%	16.7%
EPS YoY %	7.8%	2.3%	-5.6%	6.6%	19.4%
EBITDA Margin (%)	55.7%	55%	56.1%	53.7%	54.9%
EBIT Margin (%)	48.9%	50.1%	50.1%	47.9%	49%
Net Profit Margin (%)	44.2%	42.8%	37.4%	35.9%	37.4%
Net Gearing (%)	Net Cash	Net Cash	Net Cash	Net Cash	Net Cash
P/E (x)	6.7	6.5	6.9	6.5	5.4
P/B (x)	1	0.9	0.9	0.8	0.8
EV/EBITDA(x)	5	4.8	4	3.5	2.8
Dividend payout ratio (%)	18%	35%	40%	45%	50%
Dividend Yield (%)	2.6%	5.4%	5.8%	6.9%	9.2%
Inventory Days	83	89	89	89	89
Receivable Days	184	177	174	172	170
Payable Days	29	22	22	23	24
Cash Cycle	238	244	241	239	237
ROE %	14.7%	14.2%	14%	12.9%	12.8%
ROA %	12.4%	12.7%	11.2%	10.6%	11.7%

Appendix 1

Gross lottery sales allocation



Source: Company

Appendix 2

	REXLot (555 hk)	LotSynergy (1371 hk)	AGTech (8279 hk)	CVG (8156 hk)	VODone (82 hk)
Upstream					
Game design			✓		
Welfare CTG terminals	✓	✓		✓	
Sports CTG/SMG terminals	✓	✓			
VLT terminals		✓			
Self-service lottery system				✓	
SC validation and printing	✓				
Downstream					
SC distribution	✓				
Store operation or mangement	✓		✓	✓	
Internet Platform	✓	✓			✓
Mobile Platform	✓	✓			✓

REXLot’s Value chain (Source: Company)

Appendix 3

Questions sent to REXLot management

Does being exclusive mean the other mobile electronic platform providers in the same province cannot operate there, or has to go through REXLot, in which a distribution fee is charged?

How long does the contracts with the provinces for mobile electronic platform last?

Is REXLot able to match new games offered by provinces, which are then being offered by it mobile electronic platform, to the provincial pool base like how it does for the Welfare CTG sales?

How is the negotiation for the early renewal of CTG contracts currently?

I understand the company expressed interest in going into the Video Lottery terminal segment as China Lotsynergy's exclusive contract would have expired by then. Has the company done any talks so far with the officials?

Questions sent to China Lotsynergy’s management (REXLot’s competitor)

Firstly, I'm aware that the company is the exclusive supplier of VLT until 2015. This contract is up for renewal in 2015, what are the chances the company thinks this will be renewed?

Secondly, it was mentioned that the company expects announcing new contract wins with provinces for mobile distribution agreements, how many more has this been now?

Thirdly, is the company currently working on mobile version of VLT games?