Aristocrat Leisure

Digital strategy update

The Aristocrat Leisure (ALL) digital business could benefit from acquiring mid-scale game titles (the operating model of rival Zynga), as titles such as *Raid,* a leading role-playing game (RPG) globally, mature, and as the company seeks to diversify its mobile product offering to retain profitable users.

With a healthy ecosystem of paying daily average users (DAU), Aristocrat is managing the 'yield' of *Raid* (with an 18–24 month lifecycle), but it requires fresh (and proven) titles to retain users when *Raid* matures.

Aristocrat has large design studios and talent that can quickly identify game failure, although the inverse is not possible. By purchasing mid-scale, mid-cycle titles, Aristocrat could utilise its scope, capabilities and portfolio to cross-promote and effectively manage user acquisition (UA).

Aristocrat is due to report its FY19 result on Wednesday, 20 November. We expect significant revenue and DAU growth, but a weaker digital margin due to yield management in the second half.

Aristocrat has strong recurring revenues and has been consistently gaining market share in North America gaming operations, achieving growth in a flat market. Further digital growth and capital management opportunities are available, coupled with strong execution by management. Despite a challenging and structural slot spending decline as a backdrop, we believe the risk/reward balance remains attractive.

We maintain our Buy recommendation on Aristocrat with a $34.25 target price.

- **Titles strategy –** *Raid* is successful, although it requires supporting titles to back-fill in-house game design, which does not always work. For example, *Toy Story (TS)* was forecast to be more successful than *Gummy Drop*, although this is not yet the case, and we do not believe its monetisation mechanics have been successful on a platform that should be a hit-success. *Raid* has received significant UA value due to featuring, and it showcases the ideal game development lifecycle, although these successes cannot be guaranteed in the future.

- **'Buy and scale' strategy –** Successful developers can utilise a buy and scale strategy for growing mid-scale, mid-cycle titles. US rival Zynga has acquired nine games in the past eight years to fuel growth (+64% average revenue per DAU, with DAU flat in 3Q19 versus 3Q18). We anticipate Aristocrat will look favourably upon mid-scale, mid-cycle games to deliver growth within the existing ecosystem of highly profitable DAUs (OMLf 9.2m).

- **Migration to new titles –** Aristocrat can migrate highly profitable users to new titles within the same genre via cross-promotion. Having a broad ecosystem of DAUs means Aristocrat can offer existing *Raid* players similarly high-margin RPG games as it reaches maturity. Back-filling *Raid* with a mid-size (but proven) game and utilising meta or live operations capabilities to scale and monetise the platform would prevent leakage of these highly profitable cohorts, while diversifying the paying base. Cannibalisation within the ecosystem is unlikely a concern as the retention of paying players within Aristocrat is paramount to preventing leakage.

- **FY19 earnings forecasts –** We forecast an FY19 NPATA* of $870.6m, up 19.3% on FY18. Our operating earnings estimates are $1,078.7m for the Americas (up 25.6% on FY18), $520m for Digital (up 18.7%) and $217.1m for Australia and New Zealand (up 4.8%).

* NPATA is normalised profit after tax before amortisation of acquired intangibles.

Recommendation
Buy
Risk
Higher
Target price
$34.25
Last price
$31.32

Price Performance

- ALL share price (A$)
- S&P/ASX 200 (rebased)

Price Performance

	YTD	1m	3m	12m
Abs	43.4%	1.5%	3.3%	-0.5%
Rel	24.6%	-1.0%	4.4%	-0.7%

Company Data

Shares O/S (mn)	639
52-week range ($)	32.61-20.66
Market cap ($ mn)	13,840.92
Exchange rate	1.45
Free float(%)	90.2%
3M – Avg daily vol (mn)	1.96
3M – Avg daily val ($ mn)	41.1
Volatility (90 Day)	21
Index	ASX 100
BBG BUY|HOLD|SELL	12|3|1

Key Metrics (FYE Sep)

$ in millions	FY18A	FY19E	FY20E	FY21E
Financial Estimates				
Revenue	3,624	4,395	4,868	5,179
Adj. EBITDA	1,312	1,539	1,705	1,789
Adj. EBIT	973	1,143	1,314	1,398
Adj. net income	617	739	901	983
Adj. EPS	0.97	1.16	1.41	1.54
BBG EPS	1.18	1.37	1.59	1.73
Cashflow from operations	934	1,192	1,261	1,362
FCFF	812	1,042	1,076	1,131
Margins and Growth				
Revenue growth	47.7%	21.3%	10.8%	6.4%
Gross margin	-	-	-	-
EBITDA margin	36.2%	35.0%	35.0%	34.5%
EBIT margin	26.8%	26.0%	27.0%	27.0%
Adj. EPS growth	24.6%	20.1%	21.9%	9.1%
Ratios				
Adj. tax rate	28.9%	27.5%	25.5%	25.5%
Interest cover	12.4	12.5	16.3	22.7
Net debt/Equity	1.4	0.9	0.5	0.3
Net debt/EBITDA	1.9	1.3	0.9	0.5
ROCE	19.3%	18.0%	21.2%	22.6%
ROE	40.1%	38.3%	37.7%	33.6%
Valuation				
FCFF yield	4.1%	5.2%	5.4%	5.7%
Dividend yield	1.5%	1.8%	2.0%	2.3%
EV/Revenue	6.2	5.0	4.4	4.0
EV/EBITDA	17.1	14.3	12.6	11.7
Adj. P/E	32.5	27.0	22.2	20.3

Summary Investment Thesis and Valuation

Aristocrat is a slot machine manufacturer with operations in ANZ, the Americas, and International Class III segments, as well as a fast-growing Digital division. Aristocrat has strong recurring revenues, and has been consistently gaining market share in North American gaming operations, growing well in a flat market. Further digital growth and capital management opportunities are available, and coupled with strong execution by management and the scarcity of earnings growth in the market, despite a challenging and structural slot expenditure decline, we believe risk/reward remains attractive at the moment.

Our share price target is based on our SOP valuation compounded forward to Dec-20 at Aristocrat's cost of equity and adjusted for dividends where appropriate. We calculate our SOP valuation based on the individual cash flow streams of each discrete business segment. In Aristocrat's case, we value capital expenditure, working capital and provisions at the Group level. Our group post-tax WACC is 8.6%. The key figures that make up this discount rate are a cost of equity 9.8% and post-tax cost of debt of 4.8%. We apply a beta of 0.97 within this calculation.

Performance Drivers

Factors	6M Corr	1Y Corr
Market: MSCI Australia	0.59	0.67
Sect: Cons Discretionary	0.30	0.54
Ind: Consumer Serv	0.78	0.81
Macro:		
#N/A	0.26	0.32
Non-Energy Commod	0.26	0.24
Credit Spread	0.16	-0.17
Quant Styles:		
LowVol	-0.23	-0.18
Growth	0.03	0.09
Value	0.08	0.04

Sources for: Performance Drivers – Bloomberg, Ord Minnett Quantitative and Derivatives Strategy; all other tables are company data and Ord Minnett estimates.

Zynga case study – acquisition model

Zynga has acquired nine games in the past eight years to fuel growth (+64% ARPDAU / flat DAU's). Zygna has optimised its games via an acquisition model and most recently, 'Small Giant Games' and 'Gram Games' (2018) have helped Zynga *double* its Android base. Further, Zynga sustains their core offerings through a consistent series of 'bold beats', or live events and features which seek to engage current players and attract new and/or lapsed ones.

Table 1: Zynga acquisition summary

Company	Price ($USm)	Year	Key games
Small Giant Games	560 – 80% stake	2018	Empires and Puzzles
Gram Games	250	2018	Merge Dragons! and Merge Magic! (2019 release)
Peak Games	100	2017	Board and Card games focus
PuzzleSocial	20.1	2016	
Team Chaos	na	2016	
Zindagi Games	12.5	2016	
Rising Tide Games	na	2015	
superlabs	na	2015	
NaturalMotion	527	2014	

Source: Company reports. Note: Total deal value for Small Giant Games is ~$700m, the remaining stake will be purchased over a 3 year period based on profit targets.

Why is this relevant for Aristocrat? Aristocrat can deploy a strategy that is two-fold: 1) focus on adjacent game categories where cross promotion is possible with advertising synergies; 2) grow its developer base through acquisitions which have limited marketing presence and could benefit from Aristocrat's scale and scope. The latter strategy benefits developers who are not interested in taking another round of VC funding but are looking to scale on a platform instead.

Zynga's new games in 2019: Game of Thrones Slots Casino, Tiny Royale, Puzzle Combat, FarmVille 3 and Merge Magic. In Zynga's recent 3Q19 result, Empires & Puzzles accounted for 21% of online game revenue while Merge Dragons! accounted for 22%. Scale allows for the sharing of best practices across studios, including game development, publishing and marketing.

Our US team's comments from G2E around this acquisition strategy include a strong focus on player data, cohort data and lifecycle analysis.

Aristocrat could implement an acquisition-style model of investing in games with rising popularity; scaling the business to outperform the broader genre/market. If Aristocrat can identify studios with small-to-mid sized games and utilise in-house developers and meta-gaming / live ops with a large scale ecosystem, this model could grow social casual materially.

A recent example of this approach is observed with EA's 'Apex Legends' game which was produced to address the success of its competitor, Epic Game's 'Fortnite'. Apex Legends signed ~10m players within 3 days of its launch. Arguably, Raid Shadow Legends is an example of Plarium being purchased when Raid Shadow Legends was in development but disclosed to Aristocrat during due-diligence.

Where is Digital heading?

The risk for existing titles is around the lifetime value curve moving from 18-24 months to a shorter 12 months; before the harvest phase begins.

Why is lifetime value (LTV) analysis crucial? This assists marketers in understanding the quality of their user base and provides them with confidence and flexibility to acquire users profitably.

LTV equation = {(Retention rate at any given day x ARPDAU at any given day) + (Probability of engagement at any given day x Revenue by engagement at any given day)}. LTV estimates are cohort-based (what each cohort is expected to be worth at a point in time in the future), and are impacted by retention. The LTV curve inflects downward as members of a cohort can't spend money if they have churned out of the product. Please see below.

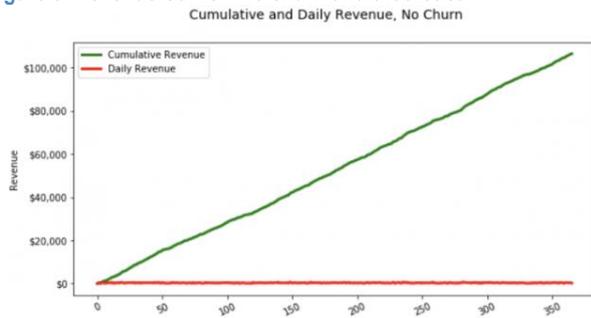**Figure 1: LTV Curve – ordinary case of peaking LTV**
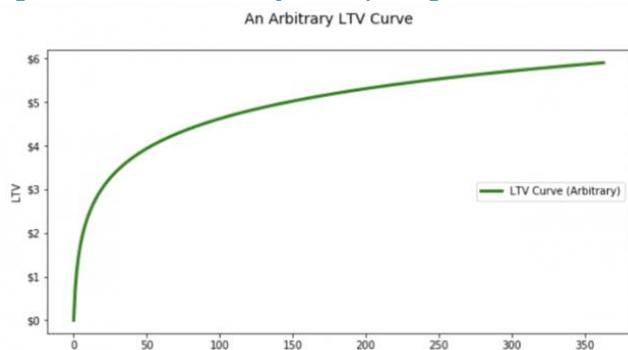
Source: mobiledevmemo. X-axis represents time in days

Figure 2: Retention Curve
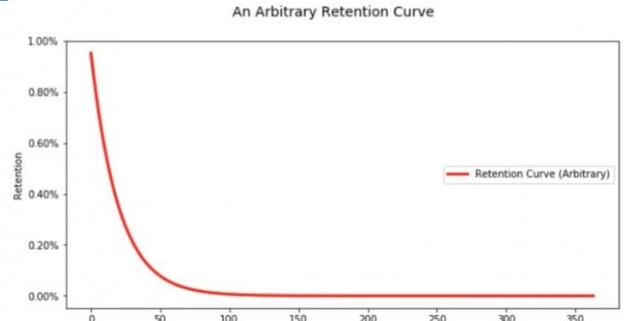
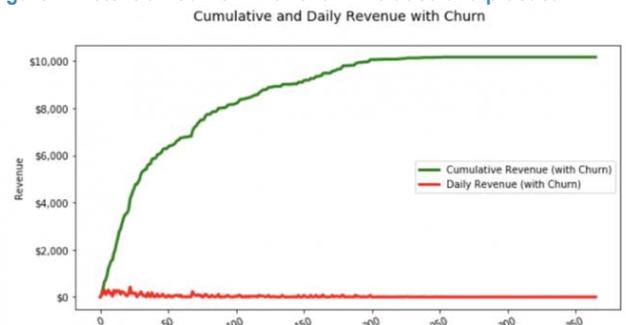Source: mobiledevmemo. X-axis represents time in days

Figure 3: Revenue Curve – no churn and theoretical

Source: mobiledevmemo. X-axis represents time in days

Curve with no churn – users in a cohort stay within the product every day for a year (assumption – 5% chance of a player paying).

Figure 4: Retention Curve – with churn included and practical

Source: mobiledevmemo. X-axis represents time in days

The long run curve with DAUs and daily churn value – normalises to the retention curve.

Social casual – US$8.3bn market size

Social casual is where Aristocrat's growth is likely to stem from as the social casino segment softens.

Plarium's Raid Shadow Legends is a role playing game (RPG) which launched in Feb 2019 (~9 months in market) and took 2 years of in house development and is now one of the leading CRPG games globally. Various other awards include #1 global game on Android and globally featuring on iOS platform. Aristocrat can use featuring to more efficiently target valuable, incremental downloads. This is supported by bloggers and influencers who create more hype and downloads.

Raid has been successful since launch and has ~ 14% of Plarium's studio staff working on the game. Aristocrat purchased Plarium after RAID was already in development and has been supportive since, their balance sheet means Plarium can be aggressive in UA.

Aristocrat's Raid Shadow Legends searches on YouTube exhibit a positive trend.

Figure 5: RAID – Platform engagement
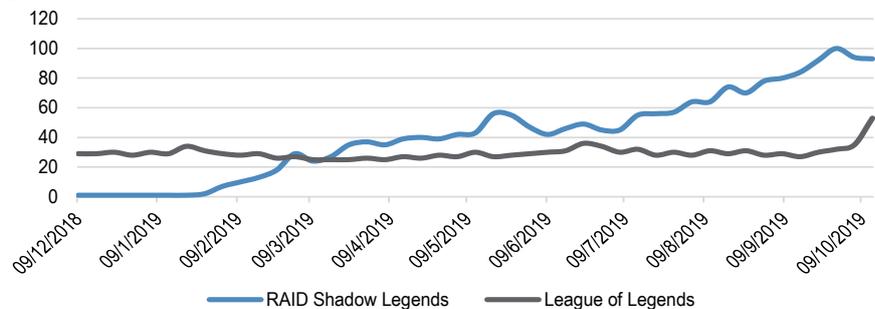
Source: Google Trends. Note: data is based on global searches for YouTube. Search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A score of 0 means there was not enough data for this term.

Users typically spend an average of 3.5 hours per day playing Raid and 70% of the users are male and 30% female. 40% are from the US, 10% from Asia, 40% from Europe, and 10% from other regions. The average age is 25-40. Raid's main competitors are Summoners War: Sky Area ($1.1b revenue in Eastern market), Star Wars Galaxy of Heroes ($450m revenue), and AFK Arena (launched in 2019 and ~$40m revenue).

Given the ramp up in marketing to support Raid Shadow Legends' bookings and DAU growth, we expect the title will receive a lower margin profile. In certain cases UA spend as a % of revenue could be greater than 100% but normalises over time.

In contrast, Toy Story has unperformed expectations as the take up rate and interest in the game has been weak. The story line and weak game play has negatively impacted monetisation. And Aristocrat has subsequently decreased UA spend and applied the 'learn fast and fail smart approach'.

Recent games like Raid Shadow Legends and Toy Story are examples of games utilising the new design loop: content creation cycle, UA strategy, and live-ops techniques; albeit the success rate is not 100%.

Despite the new launches this year, we see a slowdown in the Social *casino* category which may struggle for growth going forward.

In social casual, Aristocrat is not in 'yield play (absorbing revenue into the profit line instead of reinvesting), but could be tiling towards it in social casino as growth slows. Social casual remains in yield play as there is a risk to games profiles and Lifetime Value of a game. Aristocrat continues to focus in the revenue curve to harvest customers but not profit.

Community management

Community management is about customer relationships and how a company's brand utilises opportunities to interact with its community in online environments such as YouTube, Snapchat, Facebook, Twitter, LinkedIn, Google+ and other forums. Community management is a crucial activity for brands relying on social media to influence their marketing and sales efforts. In gaming, and specifically social casual games, community management is about creating a connection with the user base, engaging on a personalised level, but importantly, understanding their preferences. We believe Aristocrat will greatly benefit from community management (+9m DAUs) with their digital games presence by tailoring the experience to customer requirements.

The broad base of customers includes existing, target and 'other' individuals who interact with a brand both directly and indirectly online. Shopify notes it as 'it's a real person with a real personality behind real interactions:' The individuals in the community management team are viewed as advocates of the company's brand and are seem more approachable compared to a generic company account.

Benefits include complaint management, converting customer base into loyal fans, opportunities to work with key influencers and potential customers, an online 'real' voice in blogs, chats, forums and comments/review sections of websites, direct real time product feedback and the ability to network with other brands in the marketplace.

Community management vs social media marketing? Social media is focused on areas such as engagement levels, audience reach and traffic activity on the website while community management is typically the step after the social media presence is established online. The scale across both strategies varies too, social media's presence is significant while community management beings on a smaller scale and builds over time both on and outside of social media pages.

Key stages of community management
- Acquisition and content validity – Brand elevation and media market share improvement.
- Customer care – Monitoring, analysing and obtaining customer feedback.
- Crisis management – Awareness of issues and managing conflict.
- Retention – Targeted offerings and rewards to keep customers engaged.
- Advocacy – Identification and engaging with 'super fans' and brand related advocates.

Importance of revenue curves and monetisation for Aristocrat

Monetisation is the means to generate revenue in a free-to-play game. The goal is to convert the acquired and retained players into paying users. Typically these are 5% or less of the total user base for a freemium game (from the book *Freemium Economics* by Eric Seufert). The vast majority of players do not spend money, creating costs for business, and the aim is to reduce these costs by increasing the number of premium players. The revenue generated is reinvested to attract new non-viral users and expand user base.

About a decade ago, upfront paid apps was the model of choice but now a majority of app store revenue is generated from free to play apps. 79% of gaming apps will utilise in-app purchasing techniques, while 49% of all mobile app developers used in-app advertising for non-gaming. According to Statista, IHS, and Forbes, hybrid monetisation models are growing with advertising being a key lynchpin.

In Aristocrat's recent G2E 2019 presentation RAID's platform engagement was discussed along with various features on the apple and google platforms. Featuring on google play assists in driving traffic and shows the quality of the game.

Figure 6: RAID – Platform engagement
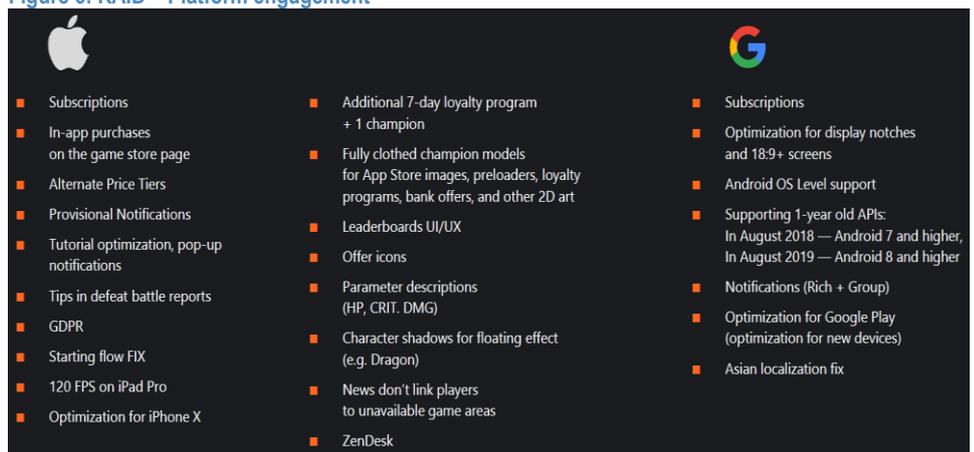
Source: Company reports.

Global digital gaming peer valuations

Mean P/E for FY19 is 22.0x whilst EV/EBITDA is 13.8x.

Table 2: Global gaming companies peer valuation

Country	Company	Ticker	Mcap (US$m)	Revenue (US$m)		P/E		EV/EBITDA		P/S	
				19E	20E	19E	20E	19E	20E	19E	20E
Korea	Netmarble Corp	251270 KS	6,799	1,941	2,216	37.6x	26.8x	17.4x	22.7x	3.5x	3.0x
Korea	NCSoft Corp	036570 KS	10,256	1,453	2,111	27.2x	15.6x	19.6x	13.1x	7.0x	4.8x
Korea	Pearl Abyss	263750 KS	2,432	509	634	18.5x	12.8x	12.4x	14.9x	4.7x	3.8x
Korea	Com2us	078340 KS	1,093	404	471	10.0x	9.0x	5.0x	6.0x	2.7x	2.3x
Korea	DoubleU Games Co	192080 KS	798	446	483	8.0x	7.1x	5.8x	8.0x	1.8x	1.6x
China	Tencent Holdings	700 HK	396,673	54,166	67,287	29.3x	24.2x	20.9x	23.6x	7.3x	5.9x
Japan	Nintendo Co	7974 JT	50,488	11,059	11,891	26.3x	22.6x	17.2x	10.3x	4.4x	4.3x
Japan	Bandai Namco Holdings Inc	7832 JT	13,669	6,365	6,997	24.6x	22.0x	12.5x	8.8x	2.1x	2.0x
Japan	Nexon Co	3659 JT	10,357	2,385	2,611	11.8x	12.2x	6.4x	7.0x	4.4x	4.0x
Japan	Konami Holdings Corp	9766 JT	6,749	2,333	2,525	19.4x	20.7x	9.4x	7.6x	2.8x	2.7x
Finland	Rovio Entertainment Oy	ROVIO FH	346	10,621	354	21.4x	12.9x	14.7x	3.9x	3.5x	1.0x
US	NetEase Inc	NTES US	37,050	10,621	1,773	21.4x	24.1x	14.7x	48.2x	3.5x	3.4x
US	Zynga Inc	ZNGA US	6,007	1,501	1,773	25.8x	24.1x	17.0x	48.2x	4.0x	3.4x
US	Activision Blizzard Inc	ATVI US	42,815	6,364	7,007	25.3x	22.0x	17.7x	11.3x	6.7x	6.1x
US	Electronic Arts Inc	EA US	28,086	4,793	5,179	24.3x	20.4x	16.2x	21.9x	5.9x	5.4x
					Mean	**22.0x**	**18.4x**	**13.8x**	**17.0x**	**4.3x**	**3.6x**
					Median	**24.3x**	**20.7x**	**14.7x**	**11.3x**	**4.0x**	**3.4x**

Source: Bloomberg, Ord Minnett estimates. As of 4-Nov-19.

Global slot peer valuations

Mean P/E for FY19 is 21.7x whilst EV/EBITDA is 7.8x.

Table 3: Global slot companies peer valuation

Country	Company	Ticker	Mcap (US$m)	Revenue (US$m)		P/E		EV/EBITDA		P/S	
				19E	20E	19E	20E	19E	20E	19E	20E
Australia	Ainsworth	AGI AU	184	161	170	23.9x	25.5x	6.4x	5.3x	1.1x	1.1x
Japan	Konami	9766 JT	6,749	2,333	2,525	19.4x	20.7x	9.4x	7.6x	2.8x	2.7x
US	International Game Technology	IGT US	2,782	4,778	4,841	11.4x	10.0x	6.6x	6.9x	0.6x	0.6x
US	AGS Play	AGS US	425	307	332	nm	26.9x	6.3x	10.4x	1.4x	1.3x
US	Scientific Games Corporation	SGMS US	2,335	3,444	3,589	nm	37.2x	7.9x	8.7x	0.7x	0.7x
US	Everi Holdings Inc	EVRI US	739	511	552	40.9x	24.2x	5.8x	5.8x	1.4x	1.3x
Canada	The Stars Group Inc	TSGI CN	6,376	2,540	2,757	12.8x	11.4x	12.0x	12.7x	2.5x	2.3x
					Mean	**21.7x**	**22.3x**	**7.8x**	**8.2x**	**1.5x**	**1.4x**
					Median	**19.4x**	**24.2x**	**6.6x**	**7.6x**	**1.4x**	**1.3x**

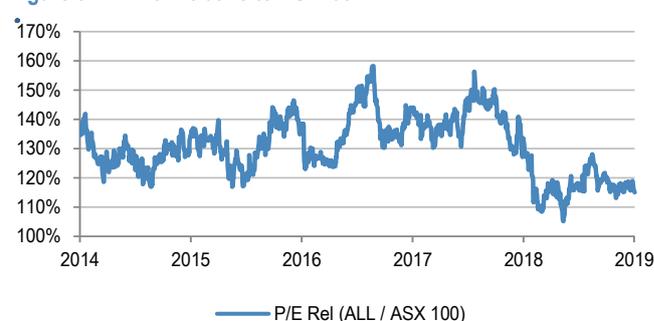Source: Bloomberg, Ord Minnett estimates. As of 4-Nov-19.

Aristocrat is trading on a P/E of 19.5x and below its ~5-year historical average of 20.3x.

Figure 7: ALL historical P/E
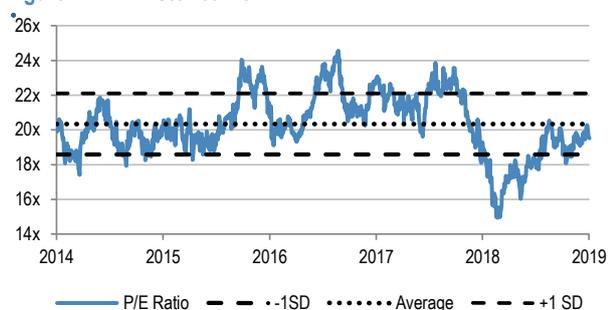
Source: Bloomberg.

Figure 8: ALL P/E relative to ASX100

Source: Bloomberg.

Earnings revisions

Key changes for the upcoming FY19 result include:

- Updated FX assumptions – increases are primarily related to favourable FX.

- Increased Digital DAUs to 9.2m from 8.2m previously.

- Decreased Digital division margins to 29.4% to reflect lower expected profit from titles.

Table 4: ALL – Earnings revisions

Year To September 2019	Revised	Previous	% Change
Revenue	4,395.2	4,301.8	2.2%
EBITDA	1,539.3	1,507.1	2.1%
NPATA	870.6	850.3	2.4%
EPSA (c) fully diluted	136.6	133.4	2.4%
DPS (c)	55.0	55.5	-0.9%
Year To September 2020			
Revenue	4,868.3	4,779.4	1.9%
EBITDA	1,704.5	1,652.5	3.1%
NPATA	1,033.7	1,002.3	3.1%
EPSA (c) fully diluted	162.2	157.2	3.1%
DPS (c)	64.0	69.0	-7.2%
Year To September 2021			
Revenue	5,179.5	5,117.5	1.2%
EBITDA	1,788.7	1,764.0	1.4%
NPATA	1,115.5	1,101.8	1.2%
EPSA (c) fully diluted	175.0	172.9	1.2%
DPS (c)	71.0	76.0	-6.6%

Source: Ord Minnett estimates.

Company Review

Private Client Research

ORD MINNETT

Table 5: ALL – Group result ($m)

	1H18	2H18	FY18	1H19	2H19E	FY19E	% pcp 2H on 2H	% pcp FY on FY
Normalised results								
Operating Revenue	1,622.0	2,002.1	3,624.1	2,105.3	2,289.9	4,395.2	14.4%	21.3%
EBITDA	635.2	676.3	1,311.5	756.3	783.0	1,539.3	15.8%	17.4%
EBITDA Margin	39.2%	33.8%	36.2%	35.9%	34.2%	35.0%	0.4%	-3.2%
EBITA	551.9	577.4	1,129.3	644.4	679.8	1,324.2	17.7%	17.3%
NPAT	310.5	306.4	616.9	356.5	382.9	739.4	25.0%	19.9%
NPATA	361.5	368.1	729.6	422.3	448.3	870.6	21.8%	19.3%
EPSA fully diluted (Acps)	56.7	57.7	114.3	66.3	70.3	136.6	21.9%	19.5%
DPS (Acps)	19.0	27.0	46.0	22.0	33.0	55.0	22.2%	19.6%

Source: Company reports and Ord Minnett estimates.

Table 6: ALL – NA and Americas summary (US$m)

	1H18	2H18	FY18	1H19	2H19E	FY19E	% pcp 2H on 2H	% pcp FY on FY
Americas Summary P&L								
Revenue	578.2	646.0	1,224.2	682.7	702.2	1,384.9	8.7%	13.1%
Segment Profit	319.1	330.8	649.9	373.8	442.4	816.2	33.7%	25.6%
Margin	55.2%	51.2%	53.1%	54.8%	63.0%	58.9%	23.0%	11.0%
NA Volume								
Platforms	6,465	6,853	13,318	8,974	8,840	17,814	29.0%	33.8%
Conversions	1,377	1,770	3,147	1,270	1,805	3,075	2.0%	-2.3%
NA Price								
ASP	18,726.0	18,639.2	18,682.0	18,512.0	18,454.1	18,483.3	-1.0%	-1.1%
NA Gaming Operations								
Class III premium	18,304	20,114	20,114	21,695	22,930	22,930	14.0%	14.0%
Class II	22,996	24,264	24,264	24,681	25,477	25,477	5.0%	5.0%
Total units	41,300	44,378	44,378	46,376	48,407	48,407	9.1%	9.1%
Total average fee per day	49.4	51.6	51.8	50.1	50.7	50.4	-1.9%	-2.8%

Source: Company reports and Ord Minnett estimates.

Table 7: ALL – Digital summary (US$m)

	1H18	2H18	FY18	1H19	2H19E	FY19E	% pcp 2H on 2H	% pcp FY on FY
Summary P&L								
Bookings	584.6	580.1	1,164.7	586.1	659.1	1,245.2	13.6%	6.9%
Revenue	577.7	587.0	1,164.7	586.8	659.1	1,245.2	12.3%	6.9%
Profit	193.7	244.5	438.2	245.9	274.1	520.0	12.1%	18.7%
Margin	0.3	0.4	0.4	0.4	0.4	0.4	-0.1%	11.0%
Key metrics								
DAU period end	8,300	8,300	8,300	8,300	8,300	8,300	0.0%	0.0%
ABPDAU	0.41	0.39	0.39	0.38	0.39	0.37	0.4%	-5.4%

Source: Company reports and Ord Minnett estimates.

Investment Thesis, Valuation and Risks

Aristocrat Leisure *(Buy; Price Target: $34.25)*

Investment Thesis

Retain Buy. Aristocrat is a slot machine manufacturer with operations in ANZ, the Americas, and International Class III segments, as well as a fast-growing Digital division. Aristocrat has strong recurring revenues, and has been consistently gaining market share in North American gaming operations. Aristocrat has significantly increased its digital exposure (36.9% of FY18 earnings) and continues to develop titles for both land-based and digital platforms. Further digital growth and capital management opportunities are available, and coupled with strong execution by management and the scarcity of earnings growth in the market, despite a challenging and structural slot expenditure decline, we believe the risk/reward remains attractive.

Valuation

Our share price target is based on our SOP valuation compounded forward to Dec-20 at Aristocrat's cost of equity and adjusted for dividends where appropriate. We calculate our SOP valuation based on the individual cash flow streams of each discrete business segment. In Aristocrat's case, we value capital expenditure, working capital and provisions at the Group level. Our group post-tax WACC is 8.6%. The key figures that make up this discount rate are a cost of equity 9.8% and post-tax cost of debt of 4.8%. We apply a beta of 0.97 within this calculation.

Risks to Rating and Price Target

Key downside risks include the consistent decline of EGM expenditure. Australian per-capita gaming expenditure has declined 0.7% on average since 2007/8, which could indicate a shift of preference within the gaming sector. This shift, coupled with technological advances, may favour emerging industries such as virtual reality or skills-based gaming. Aristocrat is also susceptible to FX exposure because it generates revenue in multiple currencies, particularly USD. There is also the ongoing risk of changes to the regulatory environment in which Aristocrat operates, which may have a material impact on earnings. The future of EGM remains questionable regarding pre-commitments, EGM expenditure caps, time caps and market size regulation.

ORD MINNETT

Aristocrat Leisure

$ in millions, year end Sep

Profit And Loss	FY17	FY18	FY19E	FY20E	FY21E
Revenue	2,454	3,624	4,395	4,868	5,179
Revenue growth	*15.3%*	*47.7%*	*21.3%*	*10.8%*	*6.4%*
COGS	(1,256)	(2,016)	(2,491)	(2,746)	(2,936)
Operating Expenses	(340)	(479)	(580)	(631)	(667)
EBITDA	**988**	**1,312**	**1,539**	**1,705**	**1,789**
EBITDA growth	*23.2%*	*32.8%*	*17.4%*	*10.7%*	*4.9%*
EBITDA margin	*40.2%*	*36.2%*	*35.0%*	*35.0%*	*34.5%*
Amortisation	(77)	(156)	(181)	(178)	(178)
Depreciation	(130)	(182)	(215)	(212)	(213)
EBIT	**781**	**973**	**1,143**	**1,314**	**1,398**
Other Income	-	-	-	-	-
Other Expenses	-	-	-	-	-
Net Interest	(53)	(105)	(123)	(104)	(79)
Pre-Tax Profit	**728**	**868**	**1,020**	**1,210**	**1,319**
Tax	(233)	(251)	(280)	(308)	(336)
Tax Rate	*32.0%*	*28.9%*	*27.5%*	*25.5%*	*25.5%*
Minorities	0	0	0	0	0
Abnormals (post tax)	0	(74)	0	0	0
Reported NPAT	**495**	**543**	**739**	**901**	**983**
Normalised NPAT	**543**	**730**	**871**	**1,034**	**1,115**
Growth	*36.5%*	*34.3%*	*19.3%*	*18.7%*	*7.9%*
End of Period Shares	638	638	637	637	637
EFPOWA	639	639	638	638	638
Reported EPS	0.78	0.85	1.16	1.41	1.54
Normalised EPS	**0.85**	**1.14**	**1.36**	**1.62**	**1.75**
Growth	*36.2%*	*34.3%*	*19.6%*	*18.7%*	*7.9%*
DPS	0.34	0.46	0.55	0.64	0.71
Growth	*36.0%*	*35.3%*	*19.6%*	*16.4%*	*10.9%*
DPS/EPS payout	43.9%	54.2%	47.4%	45.3%	46.1%

Cash Flow Statement	FY17	FY18	FY19E	FY20E	FY21E
Net Profit for Cashflow	495	543	739	901	983
Depreciation & Amortisation	206	339	396	391	391
Non Cash Items	-	-	-	-	-
Working Capital Changes	(38)	13	(30)	(31)	(11)
Other Operating Cashflows	136	39	86	0	0
Cashflow from Operating Activities	**799**	**934**	**1,192**	**1,261**	**1,362**
Capex	(214)	(270)	(315)	(346)	(381)
Net Acquisitions					
Other Investing cashflows	(90)	(72)	(76)	(83)	(92)
Investing Cash Flow	**(237)**	**(2,208)**	**(336)**	**(346)**	**(381)**
Inc/(Dec) in Borrowings	(65)	1,434	(448)	(532)	(548)
Equity Issued	0	0	0	0	0
Dividends Paid	(185)	(249)	(312)	(382)	(433)
Other Financing Cashflows	(46)	(50)	(25)	0	0
Financing Cash Flow	**(297)**	**1,135**	**(786)**	**(915)**	**(981)**
Net Cash Flow	**264**	**(119)**	**76**	**(0)**	**(0)**

Valuation Summary		$m	$ps
Current mkt capitalisation		20,019.51	31.32
Price Target			34.25
Capital growth to price target			9.4%

Trading Multiples	FY17	FY18	FY19E	FY20E	FY21E
PE Pre-abnormals	40.4	32.5	27.0	22.2	20.3
PE Reported	40.4	36.9	27.0	22.2	20.3
EV/EBITDA	20.9	17.1	14.3	12.6	11.7
EV/EBIT	26.5	23.1	19.2	16.3	15.0

Key Ratios	FY17	FY18	FY19E	FY20E	FY21E
Dividend Yield	1.1%	1.5%	1.8%	2.0%	2.3%
Franking	69.1%	100.0%	100.0%	100.0%	100.0%
Return on Assets (%)	15.8%	13.5%	12.5%	14.9%	16.2%
Return on Equity (%)	40.9%	40.1%	38.3%	37.7%	33.6%
ROIC (%)	34.7%	18.7%	22.5%	26.6%	28.3%

Leverage	FY17	FY18	FY19E	FY20E	FY21E
Gearing (Net Debt / Equity)	0.5	1.4	0.9	0.5	0.3
Gearing (ND / (ND + E))	32.6%	58.6%	48.2%	35.4%	22.0%
Net Debt / EBITDA	0.7	1.9	1.3	0.9	0.5
EBIT Interest Cover (x)	14.7	9.2	9.3	12.6	17.8

Balance Sheet	FY17	FY18	FY19E	FY20E	FY21E
Cash	547	428	504	504	504
Receivables	512	720	803	862	913
Investments	-	-	-	-	-
Inventories	116	160	226	242	257
Other Current Assets	19	44	43	43	43
Total Current Assets	**1,195**	**1,352**	**1,576**	**1,651**	**1,717**
Net PPE	241	389	446	552	701
Total Intangibles	1,688	3,899	3,823	3,674	3,514
Other Non Current Assets	169	207	180	180	180
Total Non Current Assets	**2,098**	**4,495**	**4,449**	**4,405**	**4,395**
Total Assets	**3,293**	**5,847**	**6,025**	**6,056**	**6,113**
Creditors	405	669	788	833	887
Current Borrowings	0	0	0	0	0
Current Tax Provisions	-	-	-	-	-
Other Current Provisions	44	55	56	56	56
Other Current Liabilities	204	294	323	323	323
Total Current Liabilities	**653**	**1,018**	**1,167**	**1,212**	**1,266**
Non Current Creditors	44	27	26	26	26
Non Current Borrowings	1,199	2,881	2,485	1,953	1,406
Deferred Tax Liabilities	13	123	125	125	125
Other Non Current Provisions	14	14	14	14	14
Other Non Current Liabilities	24	53	79	79	79
Total Non Current Liabilities	**1,294**	**3,097**	**2,728**	**2,196**	**1,649**
Total Liabilities	**1,947**	**4,114**	**3,896**	**3,408**	**2,915**
Equity	715	715	715	715	715
Other Equity	0	0	0	0	0
Reserves	(117)	(24)	(41)	(41)	(41)
Retained Profits	747	1,041	1,456	1,975	2,524
Outside Equity Interests	0	0	0	0	0
Total Shareholders Equity	**1,346**	**1,733**	**2,130**	**2,648**	**3,198**
Net Debt	652	2,453	1,981	1,449	902

Source: Company reports and Ord Minnett estimates.

Ord Minnett Private Client Research

Please contact your Ord Minnett Adviser for further information on our document.

Guide to Ord Minnett Recommendations

Our recommendations are based on the total return of a stock – nominal dividend yield plus capital appreciation – and have a 12-month time horizon.

SPECULATIVE BUY	We expect the stock's total return (nominal yield plus capital appreciation) to exceed 20% over 12 months. The investment may have a strong capital appreciation but also has high degree of risk and there is a significant risk of capital loss.
BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over the next 12 months.
ACCUMULATE	We expect a total return of between 5% and 15%. Investors should consider adding to holdings or taking a position in the stock on share price weakness.
HOLD	We expect the stock to return between 0% and 5%, and believe the stock is fairly priced.
LIGHTEN	We expect the stock's return to be between 0% and negative 15%. Investors should consider decreasing their holdings.
SELL	We expect the total return to lose 15% or more.
RISK ASSESSMENT	Classified as Lower, Medium or Higher, the risk assessment denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, historical volatility of its share price, nature of its operations and other relevant quantitative and qualitative criteria. Risk is assessed by comparison with other Australian stocks, not across other asset classes such as Cash or Fixed Interest.

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