Betting on France's Gambling Monopoly
Sacré (Red, White and) Bleu!

La Française des Jeux
(Paris: FDJ 34.96)

How would you like to invest in an actual monopoly? Not a business you think is a monopoly, but a real life, actual government-supported monopoly. What if this monopoly is an asset light business that is growing nicely with virtually no debt? And what if when the economy shut down during the early stages of the COVID pandemic, this business broke even and when things partially re-opened one month later business was back to normal? What if you could buy it at a 5% free cash flow yield and growing? And further, what if comps trade at much, much higher valuations such as 40 times 2024 EBITDA? Sacré bleu, can this even be a real investment opportunity?!

Well, let me introduce you to La Française des Jeux (FDJ), France's national lottery and sports gambling monopoly, that remarkably no one outside of France is paying any attention to. This extraordinary business was privatized by the French Government via an IPO in late 2019 and is simply one of the best risk/reward investments I have ever come across.

With French government bonds generating negative interest rates, an investor can buy what is effectively an arm of the French government (a lottery is effectively a tax), with a fast-growing sports gambling business, a shareholder-friendly management team, a healthy dividend, and at a completely mis-priced valuation.

As investors realize how resilient the business is, how COVID has actually made the business more profitable, and the stock starts trading closer to valuations commensurate with other gambling stocks and other monopolistic businesses, FDJ's stock has the potential to increase by over three times in the next few years. Vive la France!

France's National Lottery and Sports Gambling Monopoly

FDJ operates France's only lottery by government mandate until at least 2044 and likely a lot longer. The core lottery includes draw games such as Loto, EuroMillions and Keno, and instant, scratch games such as CASH, Solitaire, Morrison and online games. FDJ's lottery business represents 78% of revenue and 83% of profits, growing revenues at ~5% per annum and EBITDA at ~9% per annum.

The company also has the monopoly license for offline sports betting in retail establishments via its Parion brand in tobacco shops, bars and assorted retail establishments. The only place where FDJ has competition is with online sports gambling. But even in online sports gambling, competition is limited due to France's high sports gambling tax rate. Overall, sports gambling represents approximately 20% of revenue and 17% of profits.

Over the last 3 years, the online sports betting market was growing at 30%+ CAGR. After a brief dip in Q2 2020 when COVID caused a number of sporting events to be delayed/cancelled, growth has exploded in the 3rd quarter to nearly 50% YoY! As FDJ has increased investment in a better product offering and creating a true omnichannel experience, the company has started to grow its market share in the fast-growing online sports betting space while continuing to grow its monopoly retail sports betting business at a double-digit rate.

Going forward, FDJ will continue to deepen the omnichannel experience to leverage its retail monopolies in sports betting and lottery to cost effectively acquire customers for their online sports betting and lottery businesses.

France's Capitalistic Dreams

All of this sounds great, but why in the world did France privatize its money-printing national lottery and sports gambling monopolies?

President Emmanuel Macron has been making a number of pro-business investor-friendly moves to position France as a place that is attractive to capital, innovation and business. FDJ was the first company to be privatized in France under Macron's plan to turn Paris, France into a financial capital in Europe and drive more capital investment to France. The idea was to privatize a company that would be certain to perform extremely well, paving the way for future privatizations.

Consider that since privatization: (links embedded)

- France has set aside €15 billion for innovation and to encourage businesses to relocate back to France.

- And is actively using Brexit negotiations to position France as an attractive location for investors.

- Further, France has convinced institutional investors to pledge €5 billion for late-stage investment into startups.

What France is doing is actually part of a broader trend around the world in which governments are becoming more active and supportive of their own financial markets. Japan, China, the U.S. and others have been leading the way and France is now joining the party.

France is the world's seventh largest economy and could materially benefit from financial flows into its economy. Macron and the government see that and their first major step in that direction is FDJ, which despite the privatization of FDJ, the government continues to own 20% of the company.

COVID Related Shutdowns Are Turning Out to Be Very Positive

When COVID hit in March, France undertook an almost total lockdown of its economy for over one month. In the short term if you sell your lottery primarily through retail stores and all sports shutdown, that's pretty bad. But in a remarkable display, the company broke even in the second quarter and immediately returned to 2019 levels in July. The Company used the opportunity to take €80 million of costs out of the business, with COVID ultimately providing an opportunity to move much faster than normal (remember this is still France bien sûr). A good portion of those cuts were permanent, meaning medium-term margins will be higher.

FDJ had very low adoption of online lottery, historically seeing less than 5% participation. This compared poorly with other national lotteries in Australia, UK and Scandinavia, which routinely see 15% to 30% of their business through online channels. COVID has changed this for FDJ, as their online revenue percentage has almost doubled, shooting up to 9% from 5% almost overnight. This is powerful because online lottery is a much higher margin business due to the lack of paper and not having to give a cut to the retailer. The contribution margins for the online lottery are roughly double those of retail lottery.

So, what is remarkable is that FDJ is already as profitable as the pre-COVID period and in 2021, FDJ will be significantly more profitable than before. It is absolutely evident how amazingly resilient this business is. Bonjour opportunity!

Growing Lottery Moderately with Sports Betting Growth Ahead that Gushes Cash Flow

The lottery business has been growing at a 5% CAGR over the last 5 years, with the online lottery business growing at 20-30% pace over the same time period off a very low base. As mentioned above, COVID has caused a massive acceleration in the online lottery business, as it has grown to be 9% of lottery revenue from 5% at the end of 2019. Given that ~45% of lottery revenue is paid in commissions to retail partners, a shift to directly acquiring customers online creates a massive margin expansion opportunity, as online lottery margins are roughly 60% vs. 30% for retail!

For sports betting, France continues to be under-penetrated in terms of spend per capita relative to its UK and European counterparts, so market growth is expected to remain at double digit rates for the foreseeable future. Now that FDJ is privatized, FDJ will invest more heavily in its online capabilities while developing a more efficient marketing strategy to leverage its massive retail footprint and long-time brand awareness, similar to how British bookmakers GVC (London: GVC) and William Hill (London: WMH) have leveraged their retail footprints to create highly profitable, growing, market leading brands in the UK, Italy and Belgium. Given the incredibly high incremental margins in sports betting businesses, effective new customer acquisition will lead to a rapidly expanding margin profile for this business as well.

All-in-all, FDJ should be growing their revenue at a ~7% CAGR over the next 3 years. The combination of operating leverage on revenue growth plus a shift to online lottery creating meaningful margin expansion opportunity, continued share taking in the online sports space and cost cutting should lead to EBITDA growing from $400 million today to approx. $635 million in 2023, representing a more than 16% CAGR over that time period.

And FDJ is not only an asset-lite business but it converts an astonishing 86% of its EBITDA into pre-tax cash flow. Fully taxed, the free cash flow yield on the business should grow from roughly 5% to approximately 7% by 2023, with the ability to continue growing at a double-digit rate for the foreseeable future given the long-term tailwinds of online lottery penetration and sports betting share taking, all with an un-levered balance sheet! C'est so bon!

This is a cash cow of a business. So, what are they planning to do with the huge pile of cash they throw off?

Pristine Balance Sheet, Primed for Acquisitions or Buybacks

While FDJ borrowed money in a debt offering, it holds a net cash position and is generating a ton of cash. But the terms of the debt offering were compelling, borrowing at 1% interest rates. How exactly can the company borrow at those terms, yet its common equity trades at a 5% free cash flow yield?

The Company already has a stated policy of paying 80% of its net income in a nice dividend, but it could definitely do more. It could easily borrow two times EBITDA or €1 billion to fund a buyback. FDJ could easily buy back 15% of the stock in the market at current levels.

Or the company could use its cash flow or debt to buy other lottery or sports gambling businesses in France or Europe to drive even faster growth. With an unparalleled cost of capital and cash flow, expanding would be a breeze.

Maybe it could do both buybacks and acquire companies. Whatever it does, such a resilient business should utilize debt to optimize its capital structure and provide the best returns for shareholders.

Valuation Doesn't Make Sense for an Actual Growing Monopoly

How in the world does this trade at a 5% free cash flow yield and growing?

In every conversation or written word on the boom in gambling, I hear about Penn National Gaming (NASDAQ: PENN), which owns 36% of Barstool Sports, DraftKings (NASDAQ: DKNG) and FanDuel but no one ever mentions FDJ despite its crazy cash flow, monopoly position, long-term growth potential and enormous purse with which to make acquisitions.

Using DraftKings as an example, the Company expects 2021 revenue to be between $750 million and $850 million. It has a $20 billion market cap, meaning it trades for 24 times 2021 revenue. Not earnings or EBITDA, revenue! FDJ trades at 3 times the high end of revenue estimates, despite being an actual monopoly in 95%+ of its business! Now, admittedly FDJ is not growing 50% per year like DraftKings but growing EBITDA at a mid-teens rate isn't anything to sneeze at, especially considering it's actually generating tons of cash, not burning hundreds of millions a quarter like DraftKings.

And stepping away from gambling for a moment and thinking about other monopolies, monopoly infrastructure assets tend to also trade at much higher valuations than FDJ. Getlink (GET.PA), for example, the dual listed French and UK owner of the Eurotunnel toll road trades at a 2% free cash flow yield. Toll roads might not appear to be relevant comps for a lottery, yet they are both resilient monopolies except that FDJ has more growth opportunities ahead.

Risk of a Change in French Government Policy

The biggest risk is that the French government changes its mind about FDJ and decides it shouldn't be public or that it needs to pay more in taxes or the "take rate" changes. Or a new government comes in with a different philosophy around financial markets.

I will note a couple of things that mitigate these risks. First and most importantly, not only does the French government still own 20% of FDJ, but between its tax on the lottery and the tax in income FDJ pays, the government gets about 90% of the effective income from the lottery. It doesn't make much sense to blow up FDJ for the last 10%.

Second, UBFT, the wounded veterans association of France, continues to own over 10% of FDJ and has been partially funded by FDJ income for decades. In fact, the reason the French government created FDJ was to help disfigured veterans after WWI. This further insulates FDJ from any long-term change because if any future government did negatively change policy towards FDJ, they would be hurting wounded veterans as well. Ooh la la, what a bad public relations move that would be.

I would also note that the next election isn't until April or May of 2022 and that the nationalistic movement of governments around the world to support their financial markets is growing and is unlikely to change even with a new French government.

Summary

The investment case on FDJ is simple: invest in a growing, cash flowing monopoly that trades at a discount to almost every comparable company that one can think of either in the gambling space or in other monopolistic businesses. It is a hard to find a more resilient company that has actually become stronger due to the COVID pandemic.

Liberté, Égalité, Fraternité and now FDJ!

Vive la France!

Note: FDJ actually has a pretty good investor relations site that can be read in English: https://www.groupefdj.com/en/investors.html. Find more information and start your due diligence there.

Catalysts

Online lottery participation

Margin expansion

Acquisitions

Buybacks and higher dividends

Recognition of its monopoly position and absurd valuation

Discovery by foreign investors