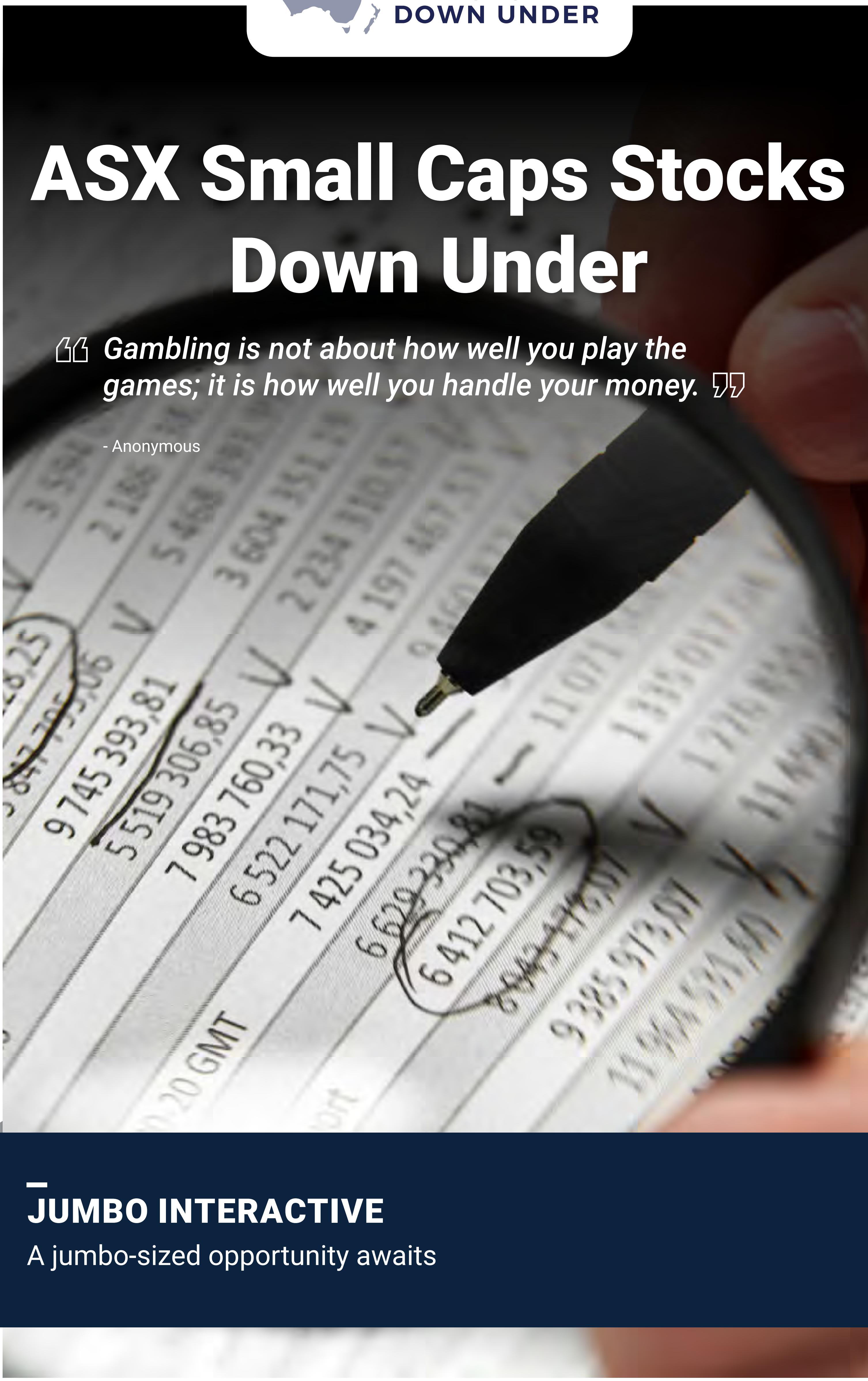

ASX Small Caps Stocks Down Under

> *Gambling is not about how well you play the games; it is how well you handle your money.*
>
> \- Anonymous

JUMBO INTERACTIVE

A jumbo-sized opportunity awaits

JUMBO INTERACTIVE

A jumbo-sized opportunity awaits

Stocks Down Under rating: ★★★★

ASX: JIN
Market cap: A$968.4M

52-week range: A$11.42 / A$19.94
Share price: A$15.42

Jumbo Interactive is a lotteries retailer and a provider of a SaaS platform that helps government and charity lottery operators do business. CY22 was a difficult year for gambling companies, something that has shown in Jumbo's share price. But unlike peers, such as The Star Entertainment Group (ASX: SGR) and Tabcorp (ASX: TAH), Jumbo has been able to grow its revenues and profit. In the years ahead, we think investors can expect more growth from this company.

Share price chart

Source: Tradingview

Watching, then jumping headfirst into the action

Jumbo Interactive has a long history, starting out in 1995 as a builder and seller of website design services. By the time it listed in 1999, it was called 'Jumbo Mall' (named after the 747 jet) and had several notable clients, including Flight Centre and RSL Lotteries. After a few years of observing the growth of online lotteries - and having a front-row seat given it had RSL Lotteries as a client - Jumbo bought a company that sold Oz Lotto and Powerball tickets online, and the rest is history.

Fast forward to 2022 and Jumbo has over 2 million players from Australia and abroad. The bulk of Jumbo's revenue comes from re-sale agreements with Tabcorp for the latter's Powerball, TattsLotto and OzLotto tickets. The most recent extension to this deal was signed in 2020, facilitating the partnership until 2030. Jumbo also has a white-label SaaS platform for other lotteries around the world to utilise and grow their lotteries, particularly in the US and the UK. With only 36% of lotteries having gone digital, we think there is more opportunity for Jumbo to capture at home and abroad.

Ever since its inception, founder Mike Veverka has remained in charge and is still a substantial shareholder, currently owning a 14.1% stake in the company.

Still growing

Unlike many tech stocks, Jumbo has not recovered to its pre-Corona Crash highs of $27. Admittedly it is well up from the $8.35 low at the bottom of the crash. But after nearly reaching $20 a share in late 2021, it is down 20% in the last 12 months. A significant challenge this company has endured, even prior to the pandemic, has been compressed margins and subsequent investor reaction to those shock announcements.

The reason for these compressed margins is increased business development, merchant and marketing costs for its SaaS business, and the lack of revenue from the SaaS business to make up for the increased costs. The acquisitions of Gatherwell in the UK and Stride in Canada also have taken longer than expected to reap revenues. And notwithstanding that the Tabcorp deal extension was good news, it included new fees that effectively halved the 9.3% commission Jumbo received. A further bad sign of the relationship with Tabcorp was the latter's sale of its stake in Jumbo, occurring less than a year after the most recent partnership extension.

Still generating strong results

Despite the underperforming share price, Jumbo Interactive has delivered good results. In FY22, Jumbo generated $659.9m in Total Transaction Value (TVV) (up 36%), $104.3m in revenue (up 25%), $55.1m in underlying EBITDA (up 13%) and a $32.2m underlying net profit (up 14%). The company's EPS was 51.5c per share and it paid out 20.5cps. The company's revenues are split 75-25 between the lottery retailing business and its SaaS business, but the EBITDA split is roughly 50-50.

Despite not issuing specific FY23 guidance, Jumbo has told shareholders it expects a 20-22% rise in operating costs and a 48-50% underlying EBITDA margin. Consensus estimates suggest $130.7m in revenue (up 25%), $63.7m in EBITDA (up 16%) and 58c EPS (up 12%).

The company's valuation multiples send mixed signals. On the one hand, its 13.1x EV/EBITDA and 0.8x EV/EBITDA to EBITDA growth suggest it is undervalued. The other, Jumbo's 24.6x P/E and 1.3x PEG (using a 19.7% Long Term Growth Rate) suggest it is moderately overvalued. We prefer to look at the former valuation metrics though.

For the first four months of FY23, Jumbo recorded 9.7% growth in lotteries revenue and 7.1% growth in SaaS revenue. Although these figures put it on track to miss consensus estimates, there were some positive signs elsewhere in its results. Two signs in particular were strong customer growth during jackpot periods and the integration of StarVale following its acquisition and integration into Jumbo's platform. StarVale is a A$32m UK society lottery services, including the state-run lottery and charity raffles, along with a digital payments business. This deal took several months for the regulator (the Great Britain Gambling Commission) to approve, which concerned shareholders all the while. Thankfully for Jumbo, the green light came back in November, boosting Jumbo's active player base to over 4 million.

ESG and dividend investors stay away, growth investors come out to play

We think the four biggest risks facing Jumbo are changes in regulation, slower than expected growth, compressed margins and cyber-attacks. Investors should be particularly wary of the latter two – margin compression because this has impacted the company's share price before, and cyber-attacks because there have been plenty of high-profile examples recently. We are not overly concerned about the macroeconomic environment impacting the company as it has not done so in the past. In fact, there is research to suggest that people experiencing financial difficulties are more likely to buy lotteries and scratch tickets.

We think there are two types of investors who should stay clear of Jumbo. The first group is ESG investors, because gambling companies don't tick the ESG box. The second group is dividend-oriented investors, given Jumbo's low payout ratio and yield.

For growth-oriented investors, however, we think Jumbo is a four-star stock. As we mentioned above, we think there is an opportunity for Jumbo to capture as lotteries go digital. We are encouraged that, unlike other stocks that benefited from the shift to online activities during the pandemic, momentum has held up as the economy has re-opened. And we expect more growth to come as the purchase of StarVale begins to be reflected in Jumbo's results.

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