
Pacific Online Systems Corporation (LOTO)

BUY

Jackpot

Price	8.40
Shares Free Float (m)	107
Shares Outstanding (m)	199
Market Cap (Pb)	1.67
52 week High	16.00
52 week Low	7.30



The Lottery. The lottery has been around for a long time in the Philippines, reaching as far back as the 19th century. However, things have changed since then. The PCSO (Philippine Charity Sweepstakes Office), the sole legal conductor of the lottery, does not have a giant tombola wherein it places every single entry. Instead, the PCSO conducts online lotteries or lottos. Online lotteries started in 1995 with a single variant, Lotto 6/42, but has since spurred different versions. The legality of lotto was initially questioned but with the backing of the Supreme Court, the lotto has moved on to reach new heights.

The Company. Prior to the launch of the said online lotteries, the PCSO conducted a bid selection in order to outsource the operations of the online lotteries. Pacific Online Systems Corporation ("LOTO", "Pacific", or the "Company") was one of the companies who joined the bid selection. Engaged in the development, design, and management of online computer systems, terminals, and software for the Philippine gaming industry, LOTO was able to win the outsourcing of the operation of online lotteries for the Visayas and Mindanao (VisMin) while Prime Gaming Management Corporation is the system operator for Luzon. As a testament to LOTO's ability to meet and even exceed all of the PCSO's requirements, LOTO has locked up the operations of lotto terminals in VisMin until 2013.

Prince Anthony A. Yeung
Equities Analyst
898-7584

AB Capital Securities Inc.
8th Floor, Phinma Plaza
39 Plaza Drive, Rockwell Center,
Makati City, Philippines
Tel: 898-7555
Fax: 898-7595, 898-7597

email: abcsi@abcapital.com.ph
website: www.abcapitalonline.com

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Games. Being the operator of all online lotto terminals in Visayas and Mindano, LOTO benefits whenever a person plays any of the lotto or digit games that are available. There are three major lottos that are played the same way. Lotto 6/42, Megalotto 6/45, and Superlotto 6/49 are all played by choosing 6 numbers from the the set of possible numbers (1 to 42, 45, and 49). A player wins if he or she is able to choose correctly the 6 numbers that will be drawn by the PCSO on predetermined draw dates, Tuesday and Saturday for 6/42, Monday, Wednesday, and Friday for 6/45, and Thursday and Sunday for 6/49. Digit games, which are slightly easier to play, are also available. Depending on the variant, a player needs to create a 6, 4, 3, or 2 digit number using 0-9 for each digit. A player wins if his combination exactly matches the combination drawn by the PCSO. The 3 digit variance, popularly known as Swertres is one of the more frequently played games.

Scratch-it. Recently, through the initiative of LOTO, a new product was introduced by the Company. Already popular in other countries such as the USA, LOTO introduced scratch-it cards (also known as instants) that retail for P20.00. Players can win up to P250,000.00 on the spot and can immediately redeem their prizes and not have to wait for a draw date. LOTO is the only entity authorized by the PCSO to distribute scratch-it cards, whether through their terminals or through agents. Under its current agreement with PCSO, LOTO can produce and distribute up to 20 million scratch-it cards per year. However, should the game strongly endear itself to Filipinos, the Company is confident that a long term agreement can be entered upon with PCSO, which will give LOTO the concession to produce more scratch-it cards.



ELA with PCSO. Although it also derives revenues from its subsidiary, Lucky Circle, the bulk of Pacific's revenues comes from its online lottery operations in VisMin. While the Company won the right to do so in 1995, its latest contract with the PCSO commenced on April 2005 and will run for 8 years. Barring any major catastrophes, which the Company is well protected against, LOTO is assured of a steady stream of strong revenues up until 2013, when the contract ends. The Equipment Lease Agreement (ELA) specifies that Pacific will share in 10% of total online lottery revenues in the VisMin region or be paid a certain fee, whichever is higher in exchange for the operation and the equipment necessary to run the online lottery in VisMin.

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State of the Art Systems. In turn, Pacific has entered into lease agreements with Scientific Games and Intralot. The current contracts entered into with the two firms are coterminous with the Company's ELA with the PCSO. Scientific Games was previously the sole provider of the system and the terminals used by LOTO. However, in 2005, Scientific Games and Pacific entered into a new agreement largely due to the fact that the old system had been rendered obsolete. Under the agreement, Scientific Games would supply LOTO with the new system, the terminals needed, and the training essential for operation. In exchange Scientific Games will receive 12.5% of LOTO's revenue stemming from online lottery games ran under the system of Scientific Games. On March 13, 2006, LOTO entered into a similar agreement with Intralot. The setup is similar to the one with Scientific Games, only Intralot gets 15% of the revenue generated from online lottery and digit games run under the system of Intralot.

Terminal Roll-out. Pacific's current agreement with the PCSO calls for at least 800 terminals, to achieve commercial operations, and a maximum of 1,800. While LOTO currently has over 1,500 terminals, it took some time for the Company to get operations rolling. However, since hitting the 800 terminals needed for commercial operations on April 2005, LOTO has not looked back and has grown faster than others would expect. At the end of 2007, the Company had rolled out over 1,400 terminals all over Visayas and Mindanao. For 2008, Pacific plans to roll out 350 more terminals to bring its total to 1,750, just slightly below the maximum of 1,800. Through the first half of the year, LOTO has been aggressively rolling out terminals. Out of the 69 cities and 844 municipalities that are under the Company's territory, LOTO has a presence in 64 cities and 405 municipalities as of the end of 2007. The rolling out of terminals are not only meant to penetrate markets that were previously untapped but also to ease the burden on locations that have significantly heavy volumes.

Strong Growth. With the growth that the Company has achieved in the past three years, it is no wonder that the lottery industry in the VisMin regions has also picked up in the past three years. Lotto operations in VisMin have grown by a robust 23% on average for the past three years. The continued roll out of terminals have increased the number of tickets sold. Expansion to new locations tap players that previously did not have easy access to terminals. While multiple terminals in heavy traffic places decrease the chance that a player might be turned off by long lines. As the number of terminals continue to grow so does the Company's revenues. In the past three years, total revenue growth has averaged 27%. With more terminals on the way, 2008 promises to be just as good, if not better.

Price Increase. Another factor that will add to the Company's growth for 2008 is the price increase for Megalotto 6/49 from P10 a ticket to P20, which went into effect on January 1, 2008. The doubling of the price of a ticket will definitely boost the amount of revenue generated by the Magalotto 6/49. Although some players might play less due to the increase in price, dedicated players will play with the same frequency. A huge chunk of lottery revenues come from dedicated players who play the same numbers for all drawings. Even with the increase in price, these players will keep betting on every draw for fear that the one time they don't bet might be the time their numbers are drawn. Furthermore, the higher price leads to a faster appreciation of the jackpot prize. 55% of total revenues goes to the prize fund. Therefore, with double the price the growth of the jackpot is also doubled. Higher jackpots also lead to a higher volume of players, which all leads to higher revenues for LOTO.

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Lucky Circle. On August 29, 2007, Lucky Circle Corporation was acquired by Loto Pacific Leisure, Inc (LotoPac), a 100% owned subsidiary of LOTO. Lucky Circle is an authorized agent of PCSO and is located in SM Supermalls nationwide. The acquisition allows LOTO to share in the much bigger lotto industry of Luzon albeit in a small way. However, the bigger contribution that Lucky Circle gives is the sale of scratch-it cards. Scratch-it cards or instants, which were introduced towards the end of 2007, are sold in Lucky Circle outlets. At the end of 2007, there were a total of 56 Lucky Circle outlets nationwide. Much like the its aggressive roll out of lotto terminals, the Company plans to increase the number of Lucky Circle outlets to 100 by the end of the year. Thus giving the Company a wider reach and a bigger market for their scratch-its.



Redundancies. One state of the art system might be enough for most companies but not for Pacific. LOTO signed up two of the biggest names in the world gaming industry and this protects itself from having to rely on one system. The Company might have a long term contract with the PCSO but if the Company suddenly finds itself unable to provide PCSO with its needs then the Company will lose the contract. By having two systems running parallel to each other, online lottery operations in VisMin will continue even in the unlikely event that one of the system crashes. LOTO also has backup centers both in Cebu and in Manila. The Company's agents are also equipped with multiple lines of communications so that even if one of the service carriers has a problem, operations can still run smoothly. Adverse events may happen once in a while but a Company as prepared as LOTO will not have to worry about them.

Taking Care. LOTO may be the one handling the online lottery operations of PCSO in VisMin but it is the agents and employees of LOTO that run the terminals for them. As such, they are an integral part of the Company's success. LOTO believes in taking care of its employees in order for them to do the best job possible. This is evidenced by the fact that there has been no union labor formed by its employees. Also, upon acquiring Lucky Circle, instead of continuing the practice of hiring contractual laborers, LOTO hired regular employees. Lastly, LOTO has an employee stock ownership plan for qualified officers and employees. LOTO is steadily growing and it shares its success with its employees and shareholders alike.

Aggressive Dividends. After strong earnings in the past three years, 2007 marked LOTO's best year yet. Aside from almost tripling earnings from 2006, LOTO was finally able to wipe out the deficit it had previously incurred. At the end of 2007, the Company's balance sheet showed retained earnings of P6.5 million compared to the previous year's deficit of P128 million. With first quarter of 2008 net income near P50 million, LOTO announced its first cash dividend as a way of sharing with the stockholders the success of the Company. However, that is only the tip of the iceberg. With the future looking bright for LOTO, management is planning to give out P100 million or P0.50 per share in cash dividends annually. The Company is capable of doing so for two key reasons. The first is that earnings are expected to exceed P200 million from 2009, or possibly 2008, onwards. Secondly, unlike other companies, LOTO does not need to use a big part of its retained earnings for investments because of its contracts with Scientific Games and Intralot.

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Minimal Risks. For sure there are risks that the Company faces. Due to the nature of its business, the Company's revenues are dependent on the popularity of the games being offered by the PCSO. Although it is highly unlikely to happen, should Filipinos fall out of love with lotto then the Company's earnings will be severely affected. Secondly, the Company relies on its contracts with the PCSO, Scientific Games, and Intralot for its business and operations. The cancellation or adverse changes in any of these contracts may affect the Company's operations, financial results, and cashflows. There is also the threat of other forms of gambling, especially the illegal type, encroaching on LOTO's space. However, the Company is well aware of these risks and does its best to mitigate them.

Too Good. Despite the threats present, the Company is surely headed for new heights. The factors that are advantageous to the Company far outweigh the risks, which are also mitigated by the company. Lotto is already a way of life in the Philippines and that fact that 30% of all revenues go to charity compel more Filipinos to play. Also, LOTO has numerous redundancies as to protect against disruptions in its operations. Furthermore, in the years that the PCSO has worked with LOTO, their relationship has blossomed into a powerful tandem. The Company is confident that when the contract is up for renewal/renegotiation it will be able to convince the PCSO to resign with them.

All About the Money. Last year, the Company was at a turning point in the sense that it had finally reached positive retained earnings. But 2008 will be the launching pad of LOTO. With the growth achieved through several means such as the roll out of terminals and new games, LOTO is expected to boost its revenues by a higher rate than the previous years. Also, the Company has been streamlining its expenses leading to a much higher net income margin. Although this year's high inflation might be troublesome, the bulk of LOTO's expenses are fixed percentages of its total revenue due to its contacts with Scientific Games and Intralot. With that, the Company is expected to hit an EPS of near P1.00 this year. While its growth rate might taper off in 2009 compared to 2008, it will still be at a robust rate. Adding to LOTO's attractiveness is the fact that it is currently trading at its all time low of P7.50, making the upside much bigger.



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Valuation. Using a more conservative growth rate that is lower than what LOTO did in the first quarter, the Company's revenues are expected to hit over P700 million this year. This translates to an EPS of P0.98. At the current price of P8.40, LOTO's PE is 8.58x, which is much lower than last year's 19.37x and is also lower than what the market is currently doing at 11.3x. Furthermore, a review of its peers reveals that companies similar to Pacific are trading at an average PE of 21.71x. At its current price of P8.40, LOTO presents an upside of anywhere from 32%, if it jumps to the market average of 11.3x PE, to 153%, if it reaches a PE at par with its regional peers. Although LOTO can reach as high as P21.00, this seems unlikely given the market condition today. Also, LOTO is of below average liquidity compared to other listed companies. Companies that are less liquid are harder to trade, which often leads to discounts in the price that investors are willing to pay. As such we are applying the more conservative standard of a 30% illiquidity discount, which would put LOTO's target price at P15.00. This is much higher than what LOTO has done this year but given the fact that LOTO's earnings are growing at a high rate, this is achievable. The TP of P15.00 presents an upside of 79%, thus LOTO is clearly a buy.

When betting on the lottery, one is faced with huge odds but betting on LOTO is a sure win.

	2005	2006	2007	2008	2009
Revenue	346.68	471.78	517.33	724.26	990.84
Net Income	32.6	50.47	134.59	181.07	222.71
Shares	125.25	125.25	184.94	184.94	184.94
EPS	0.26	0.40	0.73	0.98	1.20
Book Value	71.51	121.98	395.04	577.11	799.82
BV per share	0.57	0.97	2.14	3.12	4.33
P/E	N/A	N/A	19.37	8.58	6.99