

## Financial performance of Sportech and Vernons

### Introduction

1. This appendix looks at the past and current financial performance of each of Sportech's football pools businesses (Littlewoods Pools and Zettlers Pools) and of Vernons football pools business (Vernons Pools), which is part of Ladbrokes, as well as the strategic and financial implications for Sportech of the proposed merger.

### Sportech

2. Sportech operates both Littlewoods Pools and Zettlers Pools, which it acquired in 2000 and 2002 respectively. They are accounted for as separate business units within Sportech and together make up the bulk of the group's core football gaming business. Legally they are both part of Littlewoods Promotions Limited (a wholly-owned subsidiary of Sportech).
3. According to its statutory accounts, in the year ended 31 December 2006 (after a significant restructuring of its business) Sportech's football gaming business, which includes other Littlewoods-branded games besides Littlewoods and Zettlers Pools (mainly spot the ball and lottery games), accounted for £49.6 million (81.6 per cent) of Sportech's total gross win revenue (amounts staked less prizes paid out) of £60.8 million; and £17.4 million (94.6 per cent) of Sportech's operating profit before exceptional items from continuing businesses of £18.4 million. According to Sportech's management accounts (before final adjustments), football pools gross win revenue in 2006 was £[~~50~~] and games and lotteries accounted for £[~~17.4~~] The

remainder of Sportech's business is involved with e-gaming, comprising online casino, poker, bingo and 'game on' (a website hosting a variety of soft games<sup>1</sup>).

## Littlewoods Pools

4. The financial performance of Littlewoods Pools for the four years to December 2006 and the budget for the year to December 2007, together with various key performance indicators, is summarized in Table 1.

TABLE 1 Littlewoods Pools: summary of financial performance for the five years to 31 December 2007

	Years ended 31 December				£'000
	2003	2004*	2005	2006	Budget 2007
Sales (amounts staked)					
External income					
Turnover†					
Prizes					
Gross win revenue					
Betting duty					
Other variable costs					
Gross margin					
Direct costs					
Contribution					
Overheads					
Depreciation			×		
Group services					
Operating profit					
<i>Key performance indicators</i>					
Decline in turnover year on year (%)					
Number of transactions (m)					
Average stake (£)					
Gross win ratio (%)					
Gross margin on sales (%)					
Operating margin on sales (%)					

Source: Sportech management accounts and budget.

\*This year includes an extra week's pools (53 Saturdays fell in the year) accounting for sales of £1.1 million.

†This does not represent statutory accounts turnover. Sportech's statutory profit and loss account starts from gross win revenue and gives amounts staked as a memorandum item.

5. Sales declined between 2003 and 2006 at an average annual rate of around 13 per cent. Since the overall average stake remained unaltered over the same period, this can be directly attributed to a fall in the number of customer transactions. The 2007 budget incorporates a price increase (cost per line) of 25 per cent, scheduled to

<sup>1</sup>See Appendix C, paragraph 1, for a definition of soft gambling.

occur in August 2007 (the second price increase in 13 years). It is anticipated that this, together with an enhanced direct marketing campaign aimed at increasing customer retention and recruitment, will raise the average stake and reduce the rate of fall in turnover.

6. Betting duty is payable at 15 per cent of gross win revenue. Other variable costs comprise commissions payable to collectors (generally at around [x] per cent of collector sales), royalties and copyrights. In 2004 and 2003, variable costs also included payments of £[x] and £[x] respectively to good causes. These payments ceased in April 2004 as previously agreed with the Government. Also in May 2004 Littlewoods' existing agreement with the football league in respect of royalties for football fixtures data ended. This cost £[x] in 2004 and £[x] in 2003. No new agreement has been reached with the football league, but the company has been providing for a sum of £[x] a year.
7. Direct costs comprise entry form printing, transport, telecommunications, bank charges and bad debts, whereas the main items of expenditure within overheads are staff costs, marketing, postage and subcontract services (outsourced printing and mailing). The major reason for the significantly higher level of overheads in 2004 and 2007 is a higher level of marketing expenditure. In 2004, Littlewoods conducted a national television campaign, whereas the 2007 budget allows for [x]. Group services relate to property costs, IT and accounting.
8. The source of sales by distribution channel differentiates Littlewoods from Vernons. Littlewoods (unlike Vernons) still uses traditional doorstep collection using either hand-held terminals or paper coupons.

9. An analysis of Littlewoods Pools sales by distribution channel over the five years to 31 December 2007 is set out in Table 2.

TABLE 2 Littlewoods Pools: analysis of sales by distribution channel

	Years ended 31 December				£'000
	2003	2004	2005	2006	Budget 2007
Hand-held terminals					
Paper					
Collector sales subtotal					
Overseas					
Pools Direct (postal and telephone subscriptions)					
Postal					
Direct sales subtotal					
Tote/retail					
Internet					
Total sales					

Source: Sportech management accounts and budget.

10. Table 2 illustrates that the decline in the indirect distribution channel (via UK collectors) is considerably greater than the decline in the direct distribution channel. Between 2003 and 2006 collector sales declined by [X] per cent a year on average. By contrast, direct sales declined by [X] per cent a year on average over the same period. This is because the pyramid structure of the collector channel means that loss of one collector affects a larger number of customers. Moreover, customers of the collector network tend to be older than direct customers, so the channel suffers from higher levels of natural decline in its customer base. Sales via the Internet are still very low (though they more than doubled in 2006).
11. The Littlewoods collector network generated operating profits of £[X] in 2006 giving an operating margin of [X] per cent, compared with £[X] and [X] per cent respectively for direct sales. Sportech told us that it intended to retain the Littlewoods collector network and invest in it to make it more effective.

## Zettters Pools

12. The financial performance of Zettters Pools for the four years to December 2006 and the budget for the year to December 2007, together with various key performance indicators, is summarized in Table 3.

TABLE 3 **Zettters Pools: summary of financial performance for the five years to 31 December 2007**

	Years ended 31 December				£'000
	2003	2004*	2005	2006	Budget 2007
Sales (amounts staked)					
External income					
Turnover†					
Prizes					
Gross win					
Betting duty					
Other variable costs					
Gross margin					
Direct costs					
Contribution					
Overheads					
Depreciation					
Group services					
Operating profit					
<i>Key performance indicators</i>					
Decline in turnover year on year (%)					
Number of transactions (m)					
Average stake (£)					
Gross win ratio (%)					
Gross margin on sales (%)					
Operating margin on sales (%)					

Source: Sportech management accounts and budget.

\*This year includes an extra week's pools (53 Saturdays fell in the year) accounting for sales of £[redacted].

†This does not represent statutory accounts turnover. Sportech's statutory profit and loss account starts from gross win revenue and gives amounts staked as a memorandum item.

13. The Zettters Pools business is very small by comparison with Littlewoods Pools and is declining at a slightly faster rate (15 per cent a year between 2003 and 2006 compared with 13 per cent for Littlewoods). In spite of that, Sportech told us that its profitability has been supported by keeping a very tight control on costs.<sup>2</sup>

14. An analysis of Zettters Pools sales by distribution channel over the five years to 31 December 2007 is set out in Table 4.

<sup>2</sup>Though Sportech told us that without the Littlewoods infrastructure and with full cost allocation, Zettters would not be profitable as a stand-alone business—see Appendix E, paragraph 10.

TABLE 4 **Zetters Pools: analysis of sales by distribution channel**

	Years ended 31 December				£'000
	2003	2004	2005	2006	Budget 2007
Collector					
Direct (subscription)					
Postal					
Overseas collector					

Source: Sportech management accounts and budget.

15. The annual decline in Zetters Pools sales via collectors averaged 18 per cent between 2003 and 2006, whereas direct (subscription) sales declined by 13 per cent on average.

### **Vernons Pools**

16. Vernons Pools is part of Ladbrokes. Legally it belongs to Vernons Pools Limited (a wholly-owned subsidiary of Ladbrokes). As well as the major part of the business and assets of Vernons Pools Limited, Sportech is proposing to acquire Vernons Games Limited, Vernons Financial Services Limited and Vernons Trustee Company Limited.
17. Vernons Games Limited operates fixed odds games, including games based on the Irish National Lottery, and receives a sales commission for selling the Littlewoods Spot the Ball competition. Vernons Financial Services Limited markets a range of financial services products using the pools customer database and Vernons Trustee Company Limited administers client accounts for Vernons Internet betting websites. Together with Vernons Pools Limited, these companies form one business unit (Vernons).
18. Ladbrokes told us that it considered Vernons as a non-core business, which (following the disposal of its Hilton hotels business in 2006) is mainly involved with betting and gaming through its chain of over 2,600 LBOs in the UK, the Republic of

Ireland and Belgium. Ladbrokes also derives a significant portion of its revenue from e-gaming (Internet betting and gaming) and telephone betting. In the year ended 31 December 2006, Vernons accounted for £[redacted] (around [redacted] per cent) of Ladbrokes' total gross win revenue of £970.0 million and £5.9 million (2.2 per cent) of Ladbrokes' operating profit from continuing businesses of £268.1 million.

19. The financial performance of Vernons Pools for the four years to December 2006 and the April 2007 forecast for the year to December 2007, together with various key performance indicators, is summarized in Table 5.

TABLE 5 Vernons Pools: summary of financial performance for the five years to 31 December 2007

	Years ended 31 December				£'000
	2003	2004*	2005	2006	Forecast 2007
Turnover (amounts staked)†	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Prizes					
Gross win revenue					
Betting duty					
Cost of sales					
Gross profit					
Product costs					
Overheads					
Operating profit					
<i>Key performance indicators</i>					
Decline in turnover year on year (%)					
Number of transactions ('000)					
Average stake (£)					
Customer retention rate (%)					
Gross win ratio (%)					
Gross margin on turnover (%)					
Operating margin on turnover (%)					

Source: Vernons management accounts and budget.

\*This year includes an extra week's pools (53 Saturdays fell in the year) accounting for sales of £376,000.

†This does not represent statutory accounts turnover. Ladbrokes' statutory profit and loss account starts from revenue and gives amounts staked as a memorandum item.

20. Cost of sales principally comprises commission payable to overseas agents, royalties payable for the use of football fixtures data and insurance premiums in respect of the 'Win £2 million' prize.

21. For the whole of 2003 and part of 2004, cost of sales also included payments to good causes (Foundation for Sport and Arts and the Football Trust). Vernons (like

Littlewoods) negotiated with the Government to exit from these commitments in March 2004. The saving in 2005 compared with 2004 was £[REDACTED] and in 2005 compared with 2003 was £[REDACTED].

22. In 2004, Vernons' agreement to acquire football fixtures data from its supplier came to an end. There was at the time some doubt about the legal rights surrounding such data.<sup>3</sup> However, Vernons Pools made provision in its accounts for the costs that it considered might arise from continuing to use the data. In 2006, a new agreement was entered into with the same supplier—[REDACTED]. This meant that the provision that had been made was excessive and an amount of £[REDACTED] was written back to profit in 2006. In 2006, there were also no premiums in respect of the 'Win £2 million' prize, as this risk was no longer being insured. This gave rise to a saving of £[REDACTED] in 2006 (and subsequent years) compared with 2005.
23. Product costs relate to product development and customer retention. Overheads comprise customer recruitment and promotion, payroll, distribution, building, production and administration costs.
24. After taking account of some redefinition of cost headings in 2004, product costs have remained fairly static. Customer recruitment expenditure is by definition a discretionary item, which was cut quite significantly in 2004 (by £[REDACTED] to £[REDACTED]) and has since stabilized—amounting to £[REDACTED] in 2006. Payroll costs are also a significant item, amounting to £[REDACTED] in 2006, but they have not varied significantly during the period. Other overheads are forecast to fall by £[REDACTED] from £1,532,000 in 2006 to £[REDACTED] in 2007.

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<sup>3</sup>See *British Horseracing Board v William Hill Organisation* Case C-203/02, 9 November 2004.

25. The key performance indicators show that Vernon Pools is experiencing a decline in turnover of around [X] per cent a year (compared with around [X] per cent a year for Littlewoods direct distribution and [X] per cent for its collector business). This is principally being driven by a decline in the number of customers playing the pools, as average stakes have not altered significantly.

26. Vernons has succeeded in almost maintaining profits over the five-year period (assuming it meets its 2007 forecast)—by cutting discretionary expenditure and creating efficiencies.

27. An analysis of Vernons Pools turnover by distribution channel over the five years to 31 December 2007 is set out in Table 6.

TABLE 6 Vernons Pools: analysis of turnover by distribution channel

	Years ended 31 December				£'000
	2003	2004	2005	2006	Budget 2007
Direct—telephone					
Direct—post					
Direct—retail					
Direct—online					
Direct turnover subtotal			X		
Overseas collector					
Total turnover*					

Source: Ladbrokes .

\*There are some minor differences from the turnover figures in Table 5 due to year-end statutory reporting adjustments.

28. Table 6 shows that Vernons Pools' direct turnover (total UK turnover) has declined by [X] per cent a year on average between 2003 and 2006. Overseas collector turnover has decreased marginally over the same period.

### The price paid by Sportech for Vernons

29. Sportech [X].

30. For the purposes of its bid, Sportech valued Vernons on the basis of a multiple of [X]. This was comparable with [X]. Vernons' EBIT was assessed to be in [X].
31. In addition, Sportech had identified synergies arising from the merger amounting to £[X] a year (by year two). Sportech valued these synergies in a similar manner to Vernons' [X].
32. On this basis, Sportech offered Ladbrokes £[X] for Vernons in [X] (effectively offering to pay [X]). However, Ladbrokes [X].
33. Following further negotiations, the [X].
34. Sportech told us that [X].
35. Ladbrokes told us that its advisers had valued Vernons on the basis of [X] times its [X] (ie using a very similar methodology to Sportech). The precedent for this multiple was the price Sportech had paid for Littlewoods. This resulted in a price of £[X] ([X]). Ladbrokes saw a price of £[X] (its assessment of the net present value of the actual price paid given that part of the consideration is to be deferred) as giving it a share in the synergies created by the merger.

### **Analysis of synergies**

36. In its valuation presented to the board on [X], Sportech put a value of £[X] a year on the synergies it would be able to derive by year two following a merger with Vernons. This figure has subsequently [X]. An analysis of these synergies and of restructuring costs provided to us by Sportech is set out in Table 7.

TABLE 7 Sportech: analysis of synergies following a merger with Vernons

Synergy category	£ million	
	Year 1	Year 2*
Marketing and advertising		
Payroll		
Property		
Administration		
Prizes (net of duty)		
Total synergies		
Restructuring costs		

Source: Sportech.

\*And subsequent years.

37. Sportech told us that synergy benefits would arise to it following the merger as follows:

(a) *Marketing and advertising*: [REDACTED].

(b) *Payroll*: [REDACTED].

(c) *Property*: [REDACTED].

(d) *Administration*: [REDACTED].

(e) *Prizes (net of duty)*: [REDACTED].<sup>4</sup>

38. Sportech also told us that it had assumed that restructuring costs of £[REDACTED] would be incurred in year one. These restructuring costs include [REDACTED].

<sup>4</sup>Sportech lists [REDACTED] as a merger synergy. However we note that this will [REDACTED], and should not be considered a synergy.