By Greg Peel

Casino and waging company Tabcorp <TAH.AX> is one of those stocks which should, by rights, simply be a defensive yield play. It is a cashflow business based on the concept the house always nets a percentage over time. But in the same vein as certain healthcare sector stocks in Australia, Tabcorp is so heavily dependent on government policy it cannot be

called simply defensive at all.

Which begs the question of why you'd want to own it in the first place. Tabcorp shares were flying high in the seemingly endless party that was pre-GFC Australia, but they halved in value thereafter and have never recovered. Only traders will have seen some potential from a few ups and downs in between. Investors, in the meantime, have faced lower pokie takings and GG bets, impacts from smoking bans and tax policy, and sheer uncertainty over who might or might not win specific lucrative gaming contracts from relevant governments. Tabcorp seems more of an investment in government decisions than anything else.

But it is the fact Tabcorp's share price has been in the doldrums which has encouraged shareholders to petition the company for a change in structure. Tabcorp is basically divided into two divisions: Casinos, and Wagering, Gaming & Keno. In the case of the latter, a lot depends on whether or not Tabcorp wins the Victorian wagering licence on offer late this year or early next year. Without it, there's not much excitement in W,G&K.

But on the other side of the coin, casinos are beginning to recover from their initial slide brought on by the GFC. A trading update from Tabcorp yesterday showed a 4% increase in revenues with Casinos registering 5.5%. Tabcorp wants to take advantage of this recovery and spend a bit more money on tarting up its casinos, especially in Queensland (talk about silk purses and sows' ears), with more space for VIPs and high rollers to do their dough. Actually, Tabcorp wants to spend a lot of money.

At least on shareholder perception, Tabcorp is carrying a “conglomerate discount”. These occur in companies of one or more distinct divisions in which one division is holding back the others, and hence a split into individual divisions could mean the sum of the parts is greater than the whole. It is called “unlocking the value”.

The other reason why you might split a company is because no one wants to takeover the whole company, but different suitors might be interested in one or other of the parts. Call this the Foster's ((FGL)) effect in which beer and wine together are struggling but either beer or wine or both might be attractive to someone else.

And that's supposedly the rationale behind yesterday's announcement by Tabcorp that it intends to demerge by July next year which basically means spinning off CasinoCo from The Rest which remains as Tabcorp.

In consideration of this announcement, RBS Australia is largely alone in seeing the “reverse synergy” of a demerger, suggesting two entities will “appeal to a larger investment base” and “can adopt more tailored capital structures”. Amongst other brokers, the feeling is more that the two entities will either be together worth about the same as the old one and possibly less. This is before we get on to takeover potential.

Macquarie argues Tabcorp is carrying no “material” conglomerate discount. BA-Merrill Lynch points out that the demerger exercise will cost money, and along with two sets of ongoing operational costs could even make the move value decretive. JP Morgan suggests there is no “compelling case” the two entities can perform any better than the one.

Goldmans Sachs thought that perhaps a demerger announcement might have meant there was also exciting news to deliver, such as confirmation of a Victorian licence win or government concessions won on expanding the Jupiters casino. But nup.

JP Morgan's take was that Tabcorp was simply “doing a Foster's” in making a supposedly welcome announcement at the same time as delivering bad news. That bad news is a $430m rights issue to raise funds for casino expansions.

Analysts agree that at $6.25, the rights issue is quite good value. But the problem is even management admits that $430m is probably not the end of it. Macquarie points out the Jupiters expansion only needs $175m (at this stage) but the plan is to spend $690m on Star City over two years. From the other division, there's $150m to be injected into NSW racing and some $400-500m cost if Tabcorp does win the Vic licence.

Realistically, Tabcorp's been in the doldrums and the only way forward, according to management, is to spend its way out. And that requires funding.

Which brings us to the matter of takeover potential.

Every broker agrees that the share price of a soon-to-be-demerged Tabcorp will be underpinned by expectations that a third party or parties will be interested in at least the casino business. Jamie Packer's Crown ((CWN)) is the first to come to mind, although there may be plenty of offshore interest as well.

The first hurdle to overcome, however, is the regulatory one. Gaming, as noted above, is highly regulated to begin with and then the ACCC will want to look at any local offer and the FIRB at any foreign offer.

But there's also the small matter of Tabcorp's capex schedule. Were someone to buy into CasinoCo then they would have to foot a capex bill themselves and take on the risk of success, so why not wait until the capex is spent and then see how the company looks? And in Crown's case, to buy CasinoCo would require a capital raising of its own.

Will the two entities really be rushed with suitors?

RBS is most excited about the deal and retains Buy. Merrills is relatively circumspect about the deal but retains Buy anyway, noting $6.25 is quite cheap when you consider the upside potential of a Vic licence win. Citi is leaning toward the RBS camp, suggesting two “cleaner” entities can emerge from the whole and as such retains Buy.

Macquarie has stuck to its Underperform rating, being underwhelmed by the whole notion of a takeover, while JP Morgan has upgraded from Underweight to Neutral to reflect at least some support from takeover potential.

The rest of the brokers in the FNArena database are stuck in the middle on Hold.

And to end this story where it began, note that once upon a time Tabcorp did indeed operate as a yield stock, returning 90-100% of earnings as dividends. Yesterday not only was a capital raising announced but a cut in the payout ratio from 70% to 60% was also announced. Tabcorp is a failed value stock trying to be a growth stock.

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