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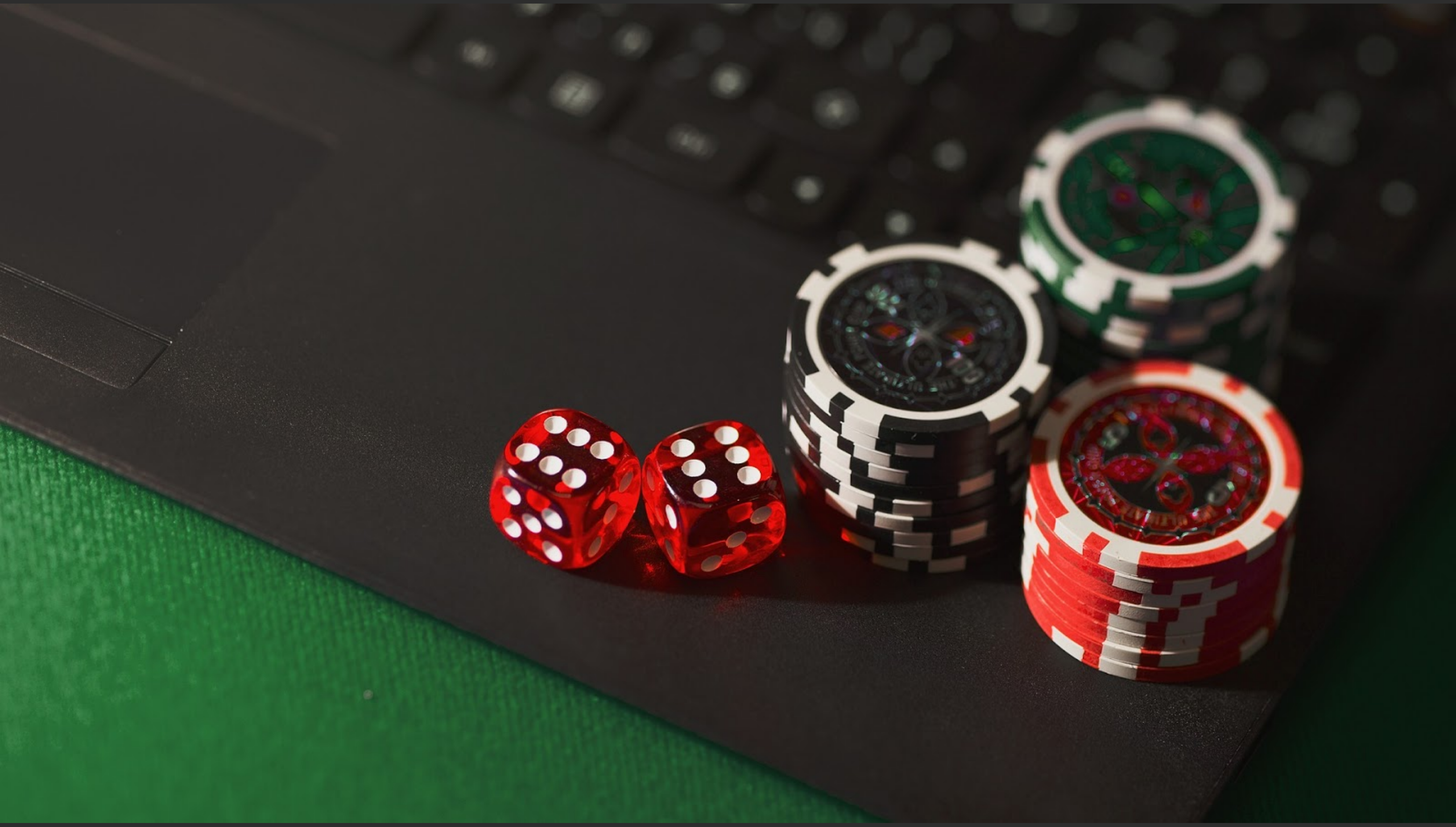
MARKET COMMENTARY



INVESTORS PLACE THEIR BETS ON GAMBLING STOCKS

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INTRODUCTION

At an investors event last November, Morgan Stanley made a bold prediction, telling participants that sports betting will become a nearly $7 billion industry in the United States by 2025, a sentiment echoed by casino executives from Hard Rock, MGM, and Mohegan Sun in attendance. While that number pales - for now - in comparison to the $41.7B raked in by American casinos in 2018, it represents the power of an industry that didn't exist prior to the Supreme Court ruling that struck down the Professional and Amateur Sports Protection Act (PASPA), handing sports betting legislation back to the states in May of 2018. Whatever the actual number is, it's clear that there's plenty of money there. Prior to the PASPA decision, the American Gaming Association estimated the illegal sports betting market was worth $150B a year.

How states manage sports betting is now left to them, but New Jersey, which took in $8.3B in sports betting revenue between June 2018 and August 2020 (Morgan Stanley may want to look at their numbers again), allows mobile and online betting made possible by providers like DraftKings, Inc. (DKNG: US) and Penn National Gaming (PENN: US). It's the modern equivalent of calling a bookie, minus the potential for getting your legs broken. 21 states have legalized gambling in one form or another, with 14 allowing online platforms accessed within state lines.

Suffice it to say, there are abundant opportunities for investors in this new industry, with some speculating that all 50 states will eventually legalize sports betting to aid in recovery efforts demanded by COVID-19's impact on retail, hospitality, tourism, and travel. Those opportunities are also shedding light on how casinos are finding ways to remain viable in an economy that has proven itself highly sensitive to connectivity-driven events like pandemics.

In this report, we will look at some of the ideas and research by SumZero's contributing members on betting and gambling investments, covering technology, platforms, and brick and mortar casinos both in the United States and around the world. This report will focus on an idea that presents peerless research analyzing retail investing as a form of gambling, the global gaming industry, the impact of the coronavirus pandemic on gambling, and more.

DRAFTKINGS: POISED TO WIN BIG

SumZero contributor **Warren Fisher,** a Principal at Manole Capital Fintech Fund and currently SumZero's #7 ranked Large Cap PM, provides one of the most comprehensive overviews of American sports betting that we have ever seen in his idea on DraftKings Inc. (DKNG).

Fisher closed his idea within a week of opening it in early September, stating that "DKNG is very volatile and hit my upside (only 10%) within the first week of this published note. We expect there will be an opportunity to purchase shares lower, once additional competitors launch." He reiterates this quality in his idea, stating that DKNG's "volatility, in terms of stock trading, is quite high and therefore should probably not be a large position for anyone's diversified portfolio" while allowing that if "(Manole) got comfortable with DKNG's market share and opportunity, factoring in its high volatility, we could see us owning a small (say 2% to 2.5%) position in DKNG."

The opportunities Fisher observes in DKNG are in online sportsbooks (OSB), which allow you to bet on sporting events; daily fantasy sports (DFS), which are essentially pooled contests in which DKNG is currently the dominant platform; and iGaming, which covers other forms of betting, including slot machines and dealer games, conducted online. For the sake of (relative) brevity, we will focus on OSB.

Fisher cites Eidlers & Krejcik Gaming sources and DKNG company reports that indicate the global TAM was worth approximately $456B in gross gaming revenue (GGR) last year. Of that amount, 16% - $73 billion - was derived from sports betting. This, Fisher notes, is where DKNG is positioned to shine, as it currently controls roughly 25% of the American market share, representing its operations in 8 of the 14 states where online sports betting is legal.

"Although most leagues have returned," Fisher writes, "COVID-19 capacity restrictions will most likely remain a headwind for physical sportsbooks locations. **We believe the greatest opportunity for sportsbooks is to embrace technology and migrate online, from physical, bricks and mortar locations. Despite no major sports getting played in the 2nd quarter, DKNG was still able to generate $75m of revenue.**" According to MarketWatch, 80% of sports bets were placed online in New Jersey.

NEW SOURCES OF STATE INCOME

It is not unreasonable to speculate that states, particularly those that have endured severe economic losses throughout the pandemic, will look toward new sources of income as relief efforts trickle and enact legislation to legalize mobile and online gambling.

Online sports betting represents a robust - if not anti-fragile - solution to the problems affecting the Consumer Discretionary sector as more and more people shift to eCommerce, online shopping, and Premium Video on Demand for the retail and entertainment needs that were formerly met by brick and mortar stores, malls, and movie theaters.

It can operate in the midst of pandemics (assuming that connectivity remains uninterrupted), is a proven revenue generator, and, unlike traditional casinos or cruise ships, which often house gaming tables, lacks the potential to exacerbate any public health crisis. This view is shared by Fisher, who writes that “with state budgets in disarray, the addressable market for mobile sports gambling in the US could increase tenfold, over the next decade” and that “with travel being restricted or considered less desirable, the opportunity for iGaming and sports gambling… has never been greater.”

Powering DKNG in its ability to attract new users is its brand recognition, amplified by strategic spending in advertising placement as sports return to television. “**In this stay-at-home environment**,” Fisher writes, “**DKNG feels it can get a positive response to its TV and radio advertising spend. Frankly, one cannot watch a NBA or NHL playoff game without being inundated with DKNG ads. It believes it is the most trusted brand, with its 8 year head start versus others in DFS.** DKNG feels that its ‘marketing machine’ is poised to deliver across multiple platforms and that it has geographic flexibility (across multiple states and countries), to scale this regulated industry.”

The earnings potential increases when other forms of gaming are added to the mix. While Fisher points out that while roughly 87% of the global GGR is still generated by casinos, online and mobile gambling has grown from 9.5% in 2015 to 12.2% in 2019, with growth he believes “should approach 15% to 20% of total GGR over the next several years.” Although regulation will shape sector and industry scalability, online and mobile gaming have been particularly successful in New Jersey, where, Fisher writes, the GGR “has shown year-over-year growth of 21%, 32%, 25%, 22% and 51%” over the last five years.

Whether or not New Jersey represents a replicable test case remains to be seen, but DraftKings’ projections rely on extrapolated data from its success in the Garden State, which leads them to calculate a U.S. sports betting market worth $18 billion a year, of which it estimates it can capture a 20 - 30% market share. Fisher’s own estimates lean more conservative, estimating an OSB market worth $12 billion.

GROWTH BY ACQUISITION

Bolstering brand strength is DKNG’s technology. In 2019, DraftKings acquired online gaming technology company SBTech through a reverse merger, which allows them to integrate better risk management tools, improve their technology and ability to innovate, and remove their dependence on a 3rd party vendor for technology.

In short, the technology should allow DKNG to make and keep more money… once it’s integrated. The challenge here is that although DKNG refers to itself throughout its 8-Ks as the only “vertically integrated sports betting company based in the United States,” it has yet to fully integrate SBTech’s technology, remaining reliant on its partnership with Kambi (KAMBI:SE) for its platform until its migration. DraftKings CEO Jason Robins addressed this during their Q1 earnings call in May. “Right now, we’re still in the early stages of planning around integration and migration,” Robins said. “Really, the goal for us is to make sure we have a high-quality migration and putting that above speed is the approach we’re taking.”

Robins' cautionary approach is wise: migration is always laden with risk and the new platform must be able to support massive amounts of traffic without crashing, which would risk not only consumers' confidence, but their money. Once this is accomplished, however, the upside is the potential for unfettered growth as demonstrated by a European competitor. "Bet365 are just light years ahead of everyone [in Europe] because they have full control of their tech stack," Sharp Gaming CEO Anthony Daniels told Legal Sports Report. "And then the focus can go on perfecting the product and acquiring customers."

DNKG WALLET TECHNOLOGY

Although that aspect of the company's technology has yet to be fully realized, Fisher is bullish on DKNG's existing tech in the form of their wallet technology, which adapts to regulatory compliance depending on what state the user is in.

"One of the key differentiators for us," Fisher writes, "is DKNG's wallet technology. As users move from state to state, from product to product, **DKNG has the capability to create compliant sub-wallets in the background. By using virtual wallets, DKNG provides a seamless experience for its players, without them ever knowing what is happening on the backend**."

"One seamless wallet," Fisher continues, "across all products, can be a game changer (no pun intended). We believe that players will become loyal to a certain brand, if the onboarding process is fairly easy. Having a low-friction experience is important and DKNG has solved this problem with simplified verification and an easy KYC (know your customer) process."

LOOKING AHEAD

While DKNG's technology potential and brand strength cannot be underestimated, there are numerous threats posed to its market share by aggressive competitors – including Penn National Gaming, Inc. (PENN), a casino and racetrack operator that also owns 36% of the wildly popular digital media company Barstool Sports – and the limits imposed by statutory legislation and regulatory compliance, which can slow market penetration.

DKNG's stock also fell slightly following a recent announcement that some early investors were selling their positions, then slipped again on October 20th when the lockup period from its June secondary offering expired and a 1.7M share block was sold for a total of $71.7 million, which at $42.15 a share, was 5 percent lower than the previous day's close. The potential for movement after lockup ending has been considered by Fisher, who noted in September that, "out of DKNG's +350 million shares outstanding, only 40% freely trade today. One could argue that increasing the tradable float is a good thing, especially if these shares head to long-term owners and investors. On the flip side, when lock-ups typically expire, DKNG could see a material oversupply of stock and selling. Many early investors have seen a huge paper windfall and may look to monetize some or all of their holdings."

That dip, combined with referendums to legalize sports betting on Louisiana, Maryland, and South Dakota's November 3rd ballots, has some investors looking at DKNG's current entry point of $42 - 44.00 as a safe bet to get into long positions.

Although Fisher sees a better entry down the road as competition heats up and potentially cuts into DKNG's market share, some retail investors are placing their bets, hoping for big wins after the elections and DKNG's upcoming Q3 earnings report on November 13th.

FEATURED MANAGER

- Warren Fisher, Founder/Principal of Manole Capital Management, long DraftKings

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