Online Gaming from Land-Based Perspective: Part Two

Observing 15th Anniversary of SIGHT

(Spectrum Internet Gaming Heuristic Theorem)

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Editor's note: In 2002, Spectrum Gaming Group developed a groundbreaking theory to project how land-based gaming and online would eventually converge: The Spectrum Internet Gaming Heuristic Theorem (SIGHT). This is the second part of our analysis of that theory, 15 years after its initial development. To access Part One, visit www.spectrumgaming.com.

Avoiding Protectionism, Protecting Gaming

This white paper, the second of two parts, begins with a basic premise: Protectionism, as a political and economic policy, is neither fair nor wise. Indeed, the history of protectionism reads like a primer on bad policy, a step-by-step how-to guide on precisely what not to do.

Part One of our white paper noted the history of how established entertainment industries were challenged by the disruptive technologies of their day, citing the prime example as to how professional baseball viewed the challenge posed by radio, the Internet of its day. We wrote that: "In the late 1920s and early 1930s, professional baseball — then in its heyday as the national pastime — was faced with the new technology of radio, which was viewed as a threat to the game's primary source of revenue: ticket sales."

That misguided reaction roughly coincided with a similarly misguided political action: passage of the infamous Smoot-Hawley Tariff Act of 1930. The more recent global economic plunge of 2008 prompted *The Economist* to note:

> The Tariff Act of 1930, which increased nearly 900 American import duties, was debated, passed and signed as the world was tumbling into the Depression. Its sponsors—Willis Hawley, a congressman from Oregon, and Reed Smoot, a senator from Utah—have come to personify the economic isolationism of the era. Sixty-three years later, in a television debate on the North American Free-Trade Agreement, Al Gore, then vice-president, even presented his unamused anti-NAFTA opponent, Ross Perot, with a framed photograph of the pair. Now, with the world economy in perhaps its worst pickle since the Depression, the names of Hawley and Smoot are cropping up again.
>
> In fact, few economists think the Smoot-Hawley tariff (as it is most often known) was one of the principal causes of the Depression. Worse mistakes were made, largely out of a misplaced faith in the gold standard and balanced budgets. America's tariffs were already high, and some other countries were already increasing their own.
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> Nevertheless, the act added poison to the emptying well of global trade. … The worldwide protection of the 1930s took decades to dismantle.[1]

Notably, our research could uncover no examples in which protectionism proved to be either effective or fair.

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[1] "The Battle of Smoot-Hawley," *The Economist*, December 18, 2008. http://www.economist.com/node/12798595

With that in mind, we have parsed another statement from Part One of our white paper: "Public policy can be best advanced by ensuring, to whatever degree is practical and politically possible, that land-based casinos be the primary operators and/or beneficiaries of online gaming."

On its face and absent context, that statement appears to contradict the widespread conclusion of many economists and analysts (including Spectrum) that protectionism is a flawed policy. That statement would also seem to support a conclusion that online operators who have developed significant experience and achieved success in European and other markets will be shut out of online gaming as it expands across the United States. Both assumptions are wrong, and clearly flawed.

Overseas online operators and providers who hope to leverage their experience, brands and other assets in the potentially burgeoning US market need to keep certain realities in mind. As Part One of our white paper made clear, online gaming – as demonstrated by the experience in New Jersey – can be an effective marketing tool to attract new demographics, and encourage those players to visit land-based casinos where they will gamble, as well as spend money in non-gaming areas, including dining, lodging and entertainment.

And, because those players can earn rewards that can be redeemed in brick-and-mortar casinos, they would play more online with such operators than they otherwise would. That statement is the rationale behind every loyalty program that presently exists in any industry: Loyalty gets rewarded, and rewards encourage loyalty.

Another reality regarding gaming in the United States is that a gaming license is considered a privilege, not a right, and that privilege is limited to federally recognized tribes and commercial operators who have earned that privilege, and have demonstrated that they possess requisite integrity. The privilege of being a gaming operator in the United States is often accompanied by some level of geographic exclusivity. States either limit the number of licenses or the potential location of casinos, or both.

Such a reality may be a form of benign protectionism. Private companies from Walmart to grocery stores to dry cleaners can locate anywhere that zoning laws permit such commercial operators. Gaming operators have no such freedom, except in locations specifically authorized by state law. In exchange for such limitations, gaming operators are encouraged – and sometimes required – to invest significant capital in their facilities. The ability to secure capital at an affordable cost is enhanced by such protections, thus everyone wins: States gain employment and tax revenue, while operators gain some level of uncertainty that their planned returns can be realized with limited risk of future competition.

Of course, not everyone wins. Applicants who were denied licenses or who lost on competitive bids are not winners. Even winning applicants are sometimes faced with negative surprises, such as more licenses being issued within their state, or new competition emerging across state lines, or through the authorization of independent retail gaming routes.

That leads to yet another reality: Politics is never a pretty process, and the politics of gaming is particularly messy. Still, risk-takers can be rewarded, often handsomely by those who understand the challenges and accept the limitations. That holds true for land-based operators in the United States, but is equally valid for online operators from overseas who seek a route into the US market: Develop a business model that adapts to realities, and leverages your core assets.

As the US market is characterized by a mosaic of political and policy differences, that means the business models – and the policies that underlie them – should be developed from a menu of certain core precepts:

- Work with land-based operators to make the political – and economic – argument that an effective online policy will engender certain fiscal and economic impacts, including employment, non-gaming spending and capital investment, that will inure to the benefit of the host states.
- Leverage their established brands, developed overseas, to develop stand-alone online sites, or position themselves as suppliers to land-based operators, to grow the online market.
- Identify markets that have, so far, traveled under the online radar, such as lotteries, to become their online suppliers.

Those options are quite distinct from each other, but they share a common thread: They are easier said than done. Online brands that have developed followings and amassed expertise and an operational infrastructure have assets that would be difficult for any land-based operator to emulate, at least not in a relatively narrow timeframe.

Here are key issues that overseas operators and suppliers need to consider when endeavoring to either plant their flag or expand their presence in the United States:

Taxation: New Jersey has a tax rate of 15 percent on online gaming revenue, and 8 percent on land-based gaming revenue. This 7 percent delta provides significant incentive for land-based operators to encourage online players to visit their casino, as that differential goes straight to the bottom line. Other states – in which slot machines are taxed at rates approaching 60 percent – cannot pursue the same business model. States must consider that when establishing tax rates on online gaming.

Lotteries: In the United States, 44 states and three territories offer lotteries. The burgeoning efforts to allow lotteries to sell tickets online will inevitably set up a conflict with casinos in those states that have both commercial or tribal casinos and lotteries. As noted in

Part One of this white paper, an online instant lottery ticket is indistinguishable from an online slot machine, and lotteries will not be content simply selling draw games online.

Exclusivity: One premise behind the licensure and development of a land-based industry has been the concept of exclusivity. Commercial and tribal operations are premised on the notion of geographic exclusivity. That notion simply does not work in an online world, except in the limited context of geolocation issues in which players must be located within a state's boundaries, or on tribal land.

Legality by Game: As we did in Part One of this white paper, we sought the views of Gideon Bierer, Managing Partner of Partis Solutions, a consulting firm with a long history in online gaming. He noted:

> Some jurisdictions have focused, for various reasons, on legalizing poker but not casino games such as slots or roulette. This is despite a long-term, significant decline in the Internet poker market globally. As the New Jersey experience has shown, Internet poker is a relatively small business which tends towards monopoly due its 'network effects,' and in NJ internet casino revenue exceeds internet poker revenue by a factor of 10. Except for the very largest states, a jurisdiction allowing only Internet poker will be of little interest to the majority of overseas operators or suppliers, nor would it generate any significant tax revenue for the local government.[2]

Should poker-only become a generally accepted pathway toward the expansion of online gaming, it creates yet another set of challenges and opportunities. Liquidity – the ability of online poker sites to offer a sufficient number of players throughout various time slots – is an issue that already plagues sparsely populated Nevada and Delaware (the two other states in addition to New Jersey that offer full-blown online gaming, which have developed a compact to increase their level of player liquidity), and would become even more of an issue for tribal operators, most of whose reservations are far from population centers.

Moreover, the issue of exclusivity is itself a thorny area, as geographic distance (within a proscribed state or region) melts away in an online world. States need to exercise extraordinary care in structuring online offerings, as any such melting or elimination of geographic exclusivity will, by definition, reduce the value of a license and of a gaming property, while making it more expensive for operators to secure affordable capital investment to expand or improve their land-based offerings. Why? Because an online offering that diminishes the value of a license adds risk to the financial equation, and greater risk translates into a greater cost of capital.

Those are some of the obstacles that must be negotiated on the path toward further online approvals. But where some see obstacles, others may identify opportunities.

[2] July 10, 2017, email from Gideon Bierer.

For example, if states elect to allow casino operators – as well as potential independent operators – to limit their online offerings to poker or legal sports wagering, it could allow lotteries an open field to offer both online draw and instant games (i.e., online slot machines), thus minimizing competition or collision between these forms of gaming.

To bring this list of challenges full circle, we return to our core premise: How can online gaming be structured in any individual state or region to optimize the public benefit, to maximize the overall impact on such largely universal goals as employment, capital investment, tourism and tax revenue?

While the easiest answer is to limit online to land-based operators, that is not the only option. European operators can enter the market through offering services as white-label providers, securing independent licenses, acquisitions or by focusing on particular segments in which their experience or brands create significant barriers to would-be competitors.

Identifying Potential Beachheads, including Sports Betting

Spectrum strategic partner Lee Richardson, president of UK-based Gaming Economics, is a close observer of how the legal and political pieces of this puzzle are falling into place. He cites William Hill as a company that can serve as an effective role model for overseas operators seeking to gain a foothold in the expanding US market, particularly in sports betting. Richardson cites a recent analysis in the *Racing Post*:

> William Hill (has) welcomed news that the US Supreme Court is to look at the laws banning sports betting in New Jersey and many other states.
>
> New Jersey's governor Chris Christie is going against his former boss Donald Trump's advice given to the Supreme Court about the action.
>
> Trump's former adviser is again lining himself up against the major sports organisations such as the NFL, NBA, NHL and MLB who got his original statute legalising sports betting in New Jersey thrown out.
>
> The Supreme Court justices will review a federal appeals court's ruling last year that the 2014 New Jersey statute permitting sports betting at casinos and racetracks violated a 1992 federal law that prohibits such gambling in all states except Nevada, Delaware, Montana and Oregon.
>
> (William Hill is) already big in Nevada, handling nearly 30 per cent of sports betting in the state after merging three small sports books and rebranding them under the Hills banner.
>
> Philip Bowcock, (William) Hill’s chief executive, is right behind governor Christie, who last month said he hoped fans could be betting on NFL games "certainly in time for the Super Bowl" next February.

Bowcock said on Tuesday: “We believe it's right that all parties, including the American sports leagues, now come together and establish a new framework of regulation.

“That will enable sports betting to be enjoyed by millions of Americans. At the same time more than 100,000 jobs could be created and billions of tax raised.

“William Hill is now Nevada’s leading sports betting company and we stand ready to take advantage of an opening up of the sports betting market in other states.”[3]

William Hill spent approximately US$50 million in late 2011 to acquire three Nevada-based sportsbooks (American Wagering, Brandywine and Cal Neva Sportsbook, now all since rebranded William Hill)[4] as part of its “establish-and-learn” strategy. Soon after these acquisitions, *The Guardian*, one of the UK’s leading newspapers reported:

The acquisitions are not expected to affect William Hill's profitability hugely, as the deals are relatively small … however, they are considered to be strategically important, as having a US operating licence could become a lucrative asset if recent regulatory moves eventually end with the American gambling market opening up.[5]

Richardson views the investment by William Hill as an important beachhead that puts the organization in a leading position to capture share in a market that is poised to expand significantly. He notes that most of the large, listed sportsbook operators (Ladbrokes-Coral, PaddyPower Betfair, William Hill, Unibet, GVC) garner the clear majority of their online sportsbook revenues, and profits, from the ultra-competitive European market, consisting of both “white” and “grey” revenues.

Currently, that European market is facing a series of structural challenges, including:

- Lower relative market growth rates, as the compounded annual growth rate is likely to be reduced over the next five years.
- Marketing, compliance and personnel costs are expected to increase.
- Taxes and duties are likely to increase, as regulatory centers such as Gibraltar and Malta are amending tax regimes.

[3] Bruce Jackson, “Hills welcome decision to review New Jersey sports betting ban,” *Racing Post*, June 27, 2017. https://www.racingpost.com/news/hills-welcome-decision-to-review-new-jersey-sports-betting-ban/290974

[4] “William Hill Agrees to Acquire American Wagering, Inc. and Cal Neva Sportsbook Operations,” PRNewswire, April 14, 2011. http://www.prnewswire.com/news-releases/william-hill-agrees-to-acquire-american-wagering-inc-and-cal-neva-sportsbook-operations-119834694.html; and “William Hill Acquires Brandywine Bookmaking,” PRNewswire, May 3, 2011. http://www.prnewswire.com/news-releases/william-hill-acquires-brandywine-bookmaking-121140249.html

[5] Simon Goodley, “William Hill’s move into US market stalls in Nevada,” *The Guardian*, April 15, 2012. https://www.theguardian.com/business/2012/apr/15/william-hill-us-nevada-licence

- Regulatory challenges will increase in number and complexity. For example, the UK Gambling Commission and the Competition and Markets Authority are presently conducting enquiries on a variety of fronts, including consumer protection and related issues.

The last bullet point – which has significant implications for UK operators – was succinctly summarized in a recent article in *The Guardian*:

> The online gambling industry is facing a clampdown after the UK competition watchdog accused companies of unfairly treating customers and potentially breaking consumer law.
>
> The Competition and Markets Authority (CMA) said people were not getting the deal they expected from sign-up promotions and operators were unfairly holding on to customers' money.
>
> Without naming specific companies, the CMA said it was taking action against "a number of operators" suspected of breaking the law and would use its powers to end any illegal activities.
>
> "We know online gambling is always going to be risky, but firms must also play fair," said Nisha Arora, the CMA senior director for consumer enforcement. "People should get the deal they're expecting if they sign up to a promotion, and be able to walk away with their money when they want to."[6]

Such challenges, irrespective of whether a firm is affected by any or none of the above, make overseas expansions more attractive, particularly those with internationally recognized brands. While Richardson notes that previous efforts to expand overseas proved to be a rather mixed experience, as some UK firms found less-than-desirable outcomes from expansion efforts in Australia, for example. Still, Spectrum and Richardson suggest that the potential opportunities afforded by US expansion are too large to be ignored by firms seeking significant growth.

Conclusion

When New Jersey lawmakers took a leap of faith in 1976 to become the second casino state in the nation (after Nevada), they created an experiment that has never ceased to evolve. State after state has either accepted, rejected or modified ideas that were first unveiled four decades ago in New Jersey. Now, in the online world, New Jersey is again a Petri dish of sorts, journeying into new territory as one of the first three states (along with Delaware and Nevada) to offer in-state online gaming.

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[6] Angela Monaghan, "Online gambling firms face clampdown after watchdog's probe," *The Guardian*, June 23, 2017. https://www.theguardian.com/society/2017/jun/23/online-gambling-clampdown-cma-investigation

As it was in 1976, New Jersey provides the most appropriate example as it is a densely populated state with a land-based industry centered in Atlantic City. The redevelopment of Atlantic City was the primary impetus behind putting the 1976 gaming referendum on the ballot, and that remains a key motivator in online.

As in land-based gaming, states that are considering their own online ventures can pick and choose from a menu of options and need to look at the experience in New Jersey, as well as other states. For example, while New Jersey limited online gaming to land-based operators, it allowed land-based operators to form partnerships with third-party operators. Notably, that bifurcated structure has worked to benefit land-based operators by growing their overall databases and encouraging land-based visits from online players, as detailed in our first installment.

While all online operators must meet New Jersey's licensing standards, and all online gaming revenues are subject to a 15 percent tax (while land-based revenue is taxed at 8 percent), the terms of agreement are worked out by the online and land-based operators.

This effectively means that New Jersey offers two forms of online gaming: one that allows, and encourages, land-based operators to leverage their online databases to market their land-based casinos, and one that has no such requirement. Indeed, we note that online partners do not necessarily market their affiliation with Atlantic City operators, while some market the relative ease of playing online without having to travel to Atlantic City. Betfair notes on its site that "At BetfairCasino.com get the real-life suspense of a physical Casino from wherever you are in New Jersey. With access to multiple Live Dealer tables, it's like Atlantic City from the comfort of your home or mobile device."[7]

That is a quite effective marketing message that would clearly resonate with players who are several hours away from Atlantic City. As online gaming expands, legislators have to consider whether or not to limit online gaming to their land-based sites, or open the market up to a broader array of providers.

With a wide array of options, our core thesis is that lawmakers need to examine gaming policy through the widest prism, considering the overall impacts on tax policy, employment, capital investment, non-gaming spending and tourism, or whatever other policy considerations exist in their states.

The choices are not simple, but we do note this: With few exceptions, the choices are permanent.

[7] Betfaircasino.com. https://www.betfaircasino.com/live-casino.shtml (accessed July 9, 2017)

About This Report

This report was prepared by Spectrum Gaming Group, an independent research and professional services firm founded in 1993 that serves private- and public-sector clients worldwide. Our principals have backgrounds in operations, economic analysis, law enforcement, regulation and journalism. Spectrum holds no beneficial interest in any casino operating companies or gaming equipment manufacturers or suppliers. We employ only senior-level executives and associates who have earned reputations for honesty, integrity and the highest standards of professional conduct.

Each Spectrum project is customized to our client's specific requirements and developed from the ground up. Our findings, conclusions and recommendations are based solely on our research, analysis and experience. Our mandate is not to tell clients what they want to hear; we tell them what they need to know.

Our public-sector clients have included 16 US state and territory governments, six national governments, 14 Native American governments, and numerous gaming companies (national and international) of all sizes, both public and private. In addition, our principals have testified or presented before the following government bodies:

- British Columbia Lottery Corporation
- California Assembly Governmental Organization Committee
- Florida House Select Committee on Gaming
- Florida Senate Gaming Committee
- Georgia Joint Committee on Economic Development and Tourism
- Illinois Gaming Board
- Illinois House Executive Committee
- Indiana Gaming Study Commission
- Indiana Horse Racing Commission
- International Tribunal, The Hague
- Iowa Racing and Gaming Commission
- Louisiana House and Senate Joint Criminal Justice Committee
- Massachusetts Gaming Commission
- Massachusetts Joint Committee on Bonding, Capital Expenditures, and State Assets
- National Gambling Impact Study Commission
- New Hampshire Gaming Study Commission
- New Jersey Assembly Regulatory Oversight and Gaming Committee
- New Jersey Assembly Tourism and Gaming Committee
- New Jersey Senate Legislative Oversight Committee
- New Jersey Senate Wagering, Tourism & Historic Preservation Committee
- New York Senate Racing, Gaming and Wagering Committee
- Ohio House Economic Development Committee
- Ohio Senate Oversight Committee
- Pennsylvania Gaming Control Board
- Pennsylvania House Gaming Oversight Committee

- Puerto Rico Racing Board
- US House Congressional Gaming Caucus
- US Senate Indian Affairs Committee
- US Senate Permanent Subcommittee on Investigations
- US Senate Select Committee on Indian Gaming
- US Senate Subcommittee on Organized Crime
- Washington State Gambling Commission
- World Bank, Washington, DC

We thank Spectrum Gaming Capital for its important contributions to this report. Spectrum Gaming Capital is an investment banking and financial advisory boutique headquartered in New York City and focused solely on the international gaming business. It is specifically oriented to providing advice to developers of casinos in the context of organization, strategic partnerships and capital raising. SGC is comprised of former Wall Street and private equity executives with disciplines in gaming-focused investment banking, development, equity research and debt research. Additionally, SGC provides mid-market investment banking services and performs complex valuation work and litigation support. SGC fills the gap between gaming consultants and balance sheet-based investment banks, providing unbiased strategic guidance and access to long-term investors.

We are grateful for the valuable input provided by Spectrum strategic partner Lee Richardson of Gaming Economics, which provides independent research, insight and advice for operators and suppliers within the international e-gaming industry. Current clients are based, or have operations, in Europe, Asia and Australia.

We also thank Partis Solutions for its review of this white paper and for its additional insights. Partis Solutions is a global leader in the provision of corporate services to the Interactive Gaming & Gambling industry. Partis delivers consulting, M&A advisory and business development solutions to a diverse portfolio of international clients from across the sector. As part of the Conexus Group and sister company to Pentasia, the leading recruiting firm in the iGaming market since 2001, Partis Solutions is uniquely positioned to leverage over 15 years of collective market intelligence and industry understanding to provide tailored solutions that support the growth aspirations and strategic choices of our customers.

Valuable assistance was also provided by David Schollenberger, Partner at Healys LLP, a tri-qualified UK/US/Australian commercial lawyer who focuses on providing legal services relating to supply, licensing and use of online and land based gaming, gambling and betting services, interactive entertainment and the supply of technology goods and services.

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