THE POT THICKENS: ONLINE GAMBLING COMES OF AGE

With the pandemic accelerating internet wagering's spread around the world, a handful of seasoned global players vie with new regulation and competition to take their game to the next level.

March 2021

KEY TAKEAWAYS

- After a year when it was often the *only* form of gambling, online wagering has moved closer to eclipsing land-based casinos as the world's go-to way to place a bet.
- Some top Europe- and Australia-based providers now enjoy rates of return on cash flow three to *five* times the rate of the Consumer Discretionary sector as a whole.
- Despite online gambling companies' recent sky-high profits and growth, valuations reflect the sort of regulatory risks that have always cast uncertainty over the industry's prospects.
- Less than three years after the first states officially opened for business, online gambling in the US brings the promise of a giant new prize, along with new threats.

If it was ever a question whether internet gambling would become socially accepted in the United States, the 2021 Super Bowl should lay those doubts to rest. An estimated 7.6 million American adults bet on the game legally online, accounting for one third of total betting channel volume (which includes land-based casinos, illegal bookies, and office pools). In Illinois, a state with 10 land-based casinos (albeit all of them operating at 25% capacity due to COVID-19 restrictions), *93%* of all bets were placed via the internet. So furious was the online betting that, for about a 30-minute stretch before and after kickoff, servers for both FanDuel and DraftKings, the two largest US sports betting sites, crashed under the deluge, costing the companies tens of millions in potential wagers. For an industry that as recently as 15 years ago occupied a legal grey zone, operating from murky off-shore locales until federal officials finally cracked down, the Super Bowl snafus amount to progress: growing pains of young internet businesses struggling to meet unexpectedly spiking demand.

Across the pond and Down Under, by contrast, the online-betting industry achieved respectability long ago. During the 12 years when the US was dark before a 2018 Supreme Court decision allowed states to decide for themselves whether or not to legalize the practice, no such prohibition existed in Britain, much of Europe, or Australia. Instead, governments viewed the legalization of online betting as a way to take it out of the hands of criminals, regulate it, and milk it through taxation. Regulatory and licensing regimes evolved in these countries alongside online gambling tech, new product offerings, and a fiercely competitive environment. In the process, a handful of battle-hardened operators emerged that have since come to dominate their now-relatively mature home markets and have grabbed the inside track in many emerging ones as well. The pandemic has solidified the competitive position of these incumbents and turbocharged their profits and growth.

THE POPULAR MONOPOLY LIVE FROM EVOLUTION GAMING, A SWEDISH BASED DEVELOPER OF LIVE-STREAMED CASINO GAMES. SOURCE: EVOLUTION.

The question now is whether their run of luck can last. For all its parallels with other "hot" digital industries, it's important to remember that online gambling is still, well… gambling. During the pandemic, more people with time to burn in front of their screens has not only meant more online gambling, but also rising incidences of problem gambling, which has further intensified the scrutiny from regulators. That, in turn, has made the tightening of advertising restrictions and wager caps more likely, especially in markets with a mature regulatory environment, such as the UK. Given the online operators' sky-high profitability and growth, cash flow projections indicate that the stock market appears to be pricing in some long-term consequence to rising regulatory pressures. In other words, the conventional wisdom seems to be that investing in online gambling companies is dicey.

"Regulation is bound to come into play," says Harding Loevner analyst Samuel Hosseini. "But even if they come back to earth, there is still *plenty* of room for those figures to remain attractive. And I'm also not so convinced they are going to fall as much as people think."

"That might be right," says Samuel Hosseini, a Harding Loevner research analyst based in London. "Regulation is bound to come into play. No one expects these companies to maintain the kind of growth rates and margins we're seeing today. But even if they come back to earth, there is still *plenty* of room for those figures to remain attractive. And I'm also not so convinced they are going to fall as much as people think."

HIGHLY DISRUPTIVE FROM THE START

In 2000, a London-based company called Betfair began accepting wagers for sporting events online. Founded by a university dropout turned professional bettor and a former JPMorgan banker, Betfair was a classic early internet disruptor. Combining concepts from computer science and financial markets, the company wanted to change the way sports betting was conducted by replacing the traditional betting shop—licensed or not—with an exchange. At Betfair, bettors would propose their own "proposition" bets, the odds fluctuating based on the reception by the crowd. The counterparty for each wager wouldn't be a bookie but another gambler taking the other side. Betfair would then take a percentage, smaller than traditional bookmakers, from each transaction. Betfair's disruptive ambitions inspired an infamous ad campaign for its launch; it involved a staged funeral procession commemorating the "death of the bookmaker," in which the company founders portrayed gangsters.

Throughout the early 2000s, the UK government stayed relatively hands off, allowing the online betting industry to grow. That changed following Parliament's passage of the Gambling Act 2005, which created a system for licensing online operators and providing a range of consumer protections–effectively formalizing state oversight of the industry. In the US, regulation took a different direction. Just as in the UK, scores of online bookmakers had emerged to take bets from Americans. Most were based offshore, on Caribbean islands or in Central America, and run by a host of colorful characters: a Harvard dropout math whiz, a former drug runner from Boston, a former New York City street bookie who once shot up the computers in his Costa Rican office with a handgun, enraged that his oddsmakers took in too much money on the wrong side of a football bet. Unlike other online gambling companies, Betfair chose to avoid the US completely, which proved prescient as traditional US land-based casinos had been lobbying heavily in the halls of power against their nascent online rivals. Their efforts came to fruition in 2006 as a federal law prohibiting banks from processing transactions for online gaming entities was passed in the US and an emerging, if dodgy, growth industry was quashed.

Focusing on the UK, Betfair and a coterie of other online-focused gambling companies spent aggressively on marketing to attract bettors and gain brand recognition.[1] Meanwhile, Betfair's betting exchange was struggling. Unable to attract sufficient liquidity to fill every wager posted on the exchange, Betfair failed to find a counterparty for around 30% of them. To capture those wagers, the company ultimately decided to start an online sports book. Betfair, it turned out, had killed the traditional bookmaker but hadn't killed bookmaking. The important success factor, it turned out, wasn't the exchange model, it was simply *being online*. In time, the operating leverage of Betfair and its online gambling peers began to take hold. They achieved sufficient scale that the cost of acquiring each new punter via mass advertising started to decline. As strong players got stronger, rounds of consolidation followed. Betfair merged with its chief exchange rival, Flutter, and the combined company eventually took the latter's name. Flutter Entertainment began acquiring brands beyond sports books, while peers (Entain, William Hill, Betsson) did the same.

Over the years, these dominant players, through trial and error, developed the complex infrastructure necessary for operating online gambling businesses—the payment processing, cybersecurity systems, compliance, customer-relations and -protection facilities, the marketing expertise—and as they did so, the threat of new entrants continued to decline. The explosive popularity of mobile gambling further accelerated these trends. In Europe, wager volumes on mobile phones have been increasing by a 20% annual clip, which means that within three years, more bets should be placed through smartphones apps than computers.

WHERE THE ACTION IS

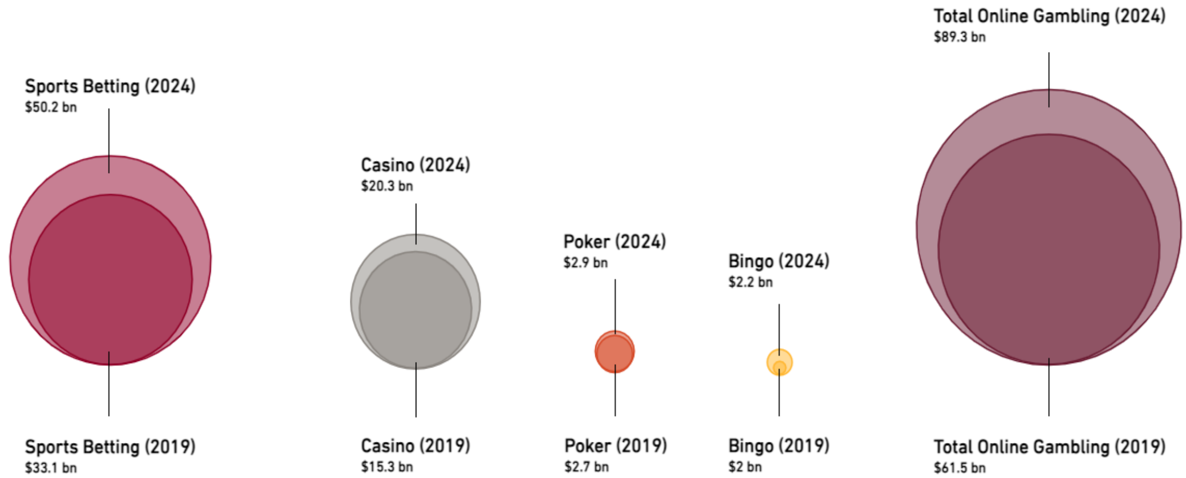
Everyone knows that the house always wins. Brick-and-mortar casinos enjoy fat profit margins: around 30% of sales on average in 2019. (By comparison, the consumer discretionary sector as a whole posted margins of around 15% in 2019.) Online gambling companies achieve similar margins, but with far less assets such as real estate and equipment. The "asset turn" for the online side of the business is thus about twice that for brick-and-mortar. Together, the high margins and low asset intensity of the online gambling sector produce "very attractive return characteristics," Samuel says.

In 2019, the online gambling sector posted a cash flow return on investment (CFROI) of 17%, more than twice the 8% generated by traditional casinos, or the 6% by the broader Consumer Discretionary sector. Two of the biggest online gambling operators in the world, Flutter and Entain (owner of Bwin, Coral, and Ladbrokes, among others), posted average CFROI of more than 25% over the last five years, four times that of the Consumer Discretionary sector as a whole.

UNPACKING THE HEADWINDS

Like tobacco and alcohol, gambling is a sin busines; thus, government oversight will always play a role in the fortunes

PROJECTED VOLUME GROWTH IN GLOBAL ONLINE WAGERING



SOURCE: HOLT

of the industry. At the heart of gambling regulation there's a tension between two competing interests. On the one hand, governments want to promote the industry's growth as a means to increase tax revenues to fund education and other social programs. On the other hand, they seek to restrain the industry in fear of the social ills—such as addiction and poverty—that gambling exacerbates. Regulatory threats to the gambling business, in other words, seem always to cast a fog of uncertainty over its prospects.

One UK proposal would set the maximum limit on online slot-machines at £2 a pull, a standard bet size at many land-based slots. While that is quite a comedown from the £200 current limit, £200 per tap of the screen would strike many as insane.

A closer look reveals a subtler picture, however. Take taxes. It's true that lawmakers won't find much popular resistance (outside the industry itself, of course) to raising taxes on gambling. If a government needs money (as almost every governments does, and even more so now post-pandemic), an activity like online gambling is "a soft target," says Samuel. But because all companies operating in a jurisdiction face the same burden, the playing field is level. Tax increases tend to get passed on to unprotesting customers in the form of incrementally lower payouts and chances of winning.

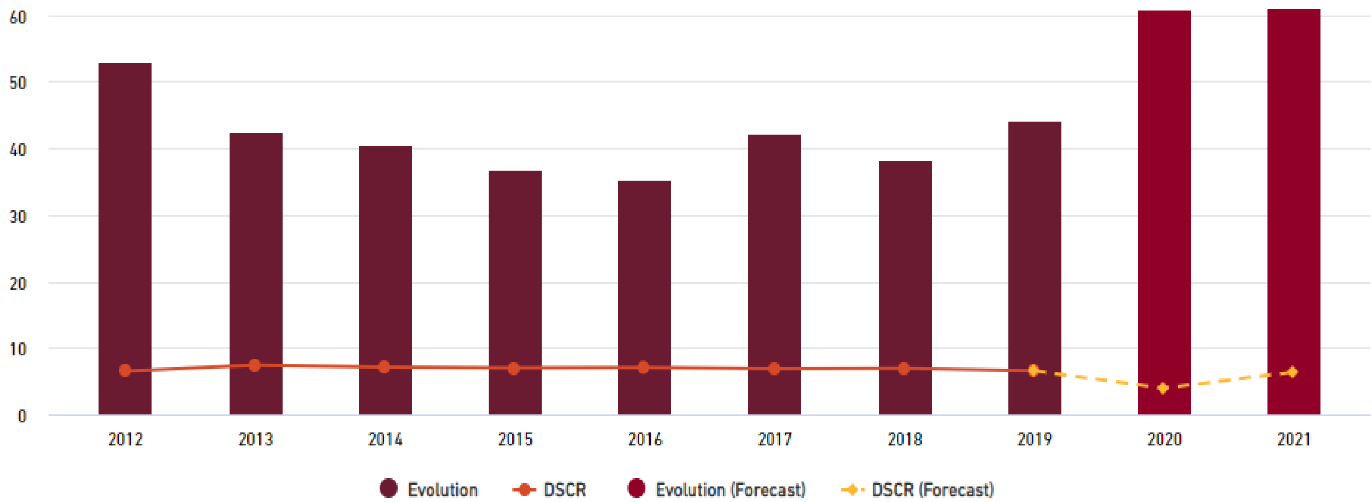
Advertising restrictions, similarly, aren't the bogeyman they might first appear. Marketing is so crucial to gaining a foothold online that limits on gambling ads tend to deter potential newcomers, thereby benefiting incumbents.

Wager caps are another regulation in any government's toolkit—a way to mitigate the potential for gambling addictions. This is an especially fraught issue now, as studies in Britain indicate a rising incidence of addiction during the past year of pandemic strictures. There have been increasing calls within the UK to further limit the size of online wagers. Again, though, the playing field is level. And a look at these proposed reductions suggests they aren't exactly draconian: for example, one proposal would set the maximum limit on online slot-machines at £2 a pull, a standard bet size at many land-based slots. While that is quite a comedown from the £200 current limit, £200 per tap of the screen would strike many as insane.

History has shown that the profit margins of the best-run online betting companies are generally resilient to regulatory pressures. The more experienced operators self-regulate, recognizing restraint and concern for the welfare of customers as part of the recipe for long-term success. In addition to funding gambling addiction programs, maintaining in-house interventions staffs and punter-controlled deposit and loss-limit features, a number of companies including Flutter increasingly use machine learning to spot and preempt the most problematic behavior. To a certain extent, a firmer governmental hand can even give bettors more confidence they will receive fair odds and proper payouts. Says Samuel, "The consensus view seems to be that these large incumbent companies should eventually see a big drop in profitability and growth because of the trend toward tighter regulations in mature markets. But that hasn't always materialized."

That's especially not been the case in what Samuel judges to be the most interesting subsector of the online-gambling industry. Situated upstream, specialist firms develop software platforms and specific games for sale or licensing to the

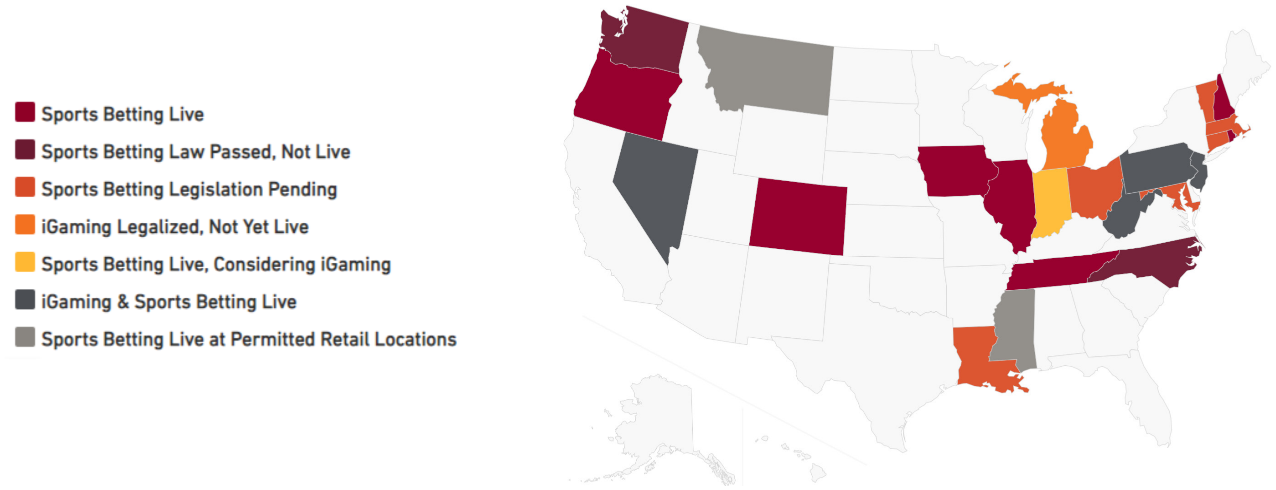
THE MOST PROFITABLE GAMBLING COMPANY YOU'VE NEVER HEARD OF



SOURCE: HOLT

Cash flow return on investment, or CFROI, is a measure of a company's economic value created as a function of the total investment in the business. The chart above shows the CFROIs for Evolution Gaming, a Swedish-based developer of live-streamed casino table games, and for the Consumer Discretionary sector as a whole.

CURRENT STATUS OF INTERNET WAGERING LEGISLATION



SOURCE: CREDIT SUISSE, ACTION NETWORK, WESTPORT DAILY VOICE

To place a bet online in the US, you must be physically located at the time in a state that currently allows online gambling. Betting sites help states with enforcement through geolocation software that works with a mobile device's GPS function or the IP address of a computer to track the user's location.

public-facing online operators. Stockholm-based Evolution Gaming, for example, specializes in producing live-streamed casino table games. Game developers have continually issued updates, keeping end users engaged with the next generation of experiences, and users have tended to recycle their winnings, a percentage of the revenues from which are shared with the developer. Their business models, then, resemble the highly profitable software-as-a-service model, with Evolution achieving an outsized CFROI of more than 40%.

The advantages of this approach can be clearly seen in one game segment, the online mega jackpot. Often, a game offering a winner-takes-all jackpot can be distributed to multiple operators, with the vendor then using its systems to pool the rewards into one pot. The sudden headline jackpot becomes a magnitude larger, drawing in a greater number of customers for the operators, and higher commissions for the vendors.

NEW WORLD ORDER

Online gambling has never enjoyed the kind of lofty stock valuations of certain other internet growth industries. Investors have evidently decided (probably rightly so) that the total addressable market for online gambling will never be as large as the one for, say, work-from-home software or e-commerce storefronts. But that is not to say the upside isn't considerable. One only need look at the relative population of mature versus immature, if not completely virgin, online gambling territory.[2]

No newly opened internet wagering markets holds as much promise as the United States, only just now emerging from its era of prohibition. The gambling industry data source H2 Gambling Capital estimated that within a few months of the 2018 Supreme Court decision online gambling in the US already had generated an annual "gross win" (the difference between gamblers' wins and losses, or effectively the companies' revenues) of US$4 billion on just 3% penetration of all US bettors. (By comparison, the UK, the world's current largest online gambling market, had a gross win of US$10 billion as of 2019 on 43% penetration.) H2 projects US gross win will grow to US$18 billion a year over the next decade.[3] Some industry watchers predict that, eventually, so many people will be betting online in so many different states that the current patchwork regulatory framework could give way to legalization at the federal level, starting with sports.

THE NON-UNITED STATES OF ONLINE GAMBLING (AT LEAST SO FAR)

For now, FanDuel and its archrival DraftKings dominate the US, together controlling 60% of the online sports betting sector, both having built formidable reputations and customer bases through years of operating as fantasy sports sites running games of "skill" with cash "prizes." It might seem that locally based companies hold an edge over international players, especially when it comes to the social networking aspect of their platforms.[4] For example, Penn National, another US domestic company, recently bought the popular video blog and social media platform Barstool Sports. DraftKings struck a partnership with the Turner Broadcasting-owned website Bleacher Report, while BetMGM teamed with Verizon, owner of Yahoo! Sports and exclusive home of mobile live-streamed NFL games. In each case, the companies aim to create betting "virtual destinations" with the potential to pull in critical masses of fans, followers, and bettors. Americans know what Americans want, and it's not a fait accompli that the seasoned overseas operators will come in and conquer.

But, then again, Europe- and Australia-based companies don't have to start from scratch, Samuel points out. With capital at hand, they can snap up promising native startups in young markets. Look no further than Flutter. In December 2020, it completed the purchase of FanDuel. Seven months earlier, it bought Stars Group, a Canada-based casino-games operator whose PokerStars brand had quickly become popular in some of the lower 48. These deals positioned Flutter as the single largest online gambling company in the US.

"If I'm going to back a player in the US, I want companies that have experience, that are established, that bring years of technology development and knowhow, that are used to adapating to evolving regulatory regimes and have cash flows from other places in the world," Samuel says. "The very fact that the European incumbents are diversified geographically across both mature and new markets is itself a defense for investors. If you bet just on one market, if the regulators get too heavy handed at some point, you could get burned."

"Diversification helps investors get some sleep at night," Samuel adds. "Then it's not such a crazy gamble."

CONTRIBUTORS

Analyst Samuel Hosseini contributed research and viewpoints to this piece.

ENDNOTES

[1]Partly because of the enormous marketing expense involved in online gambling, many early UK players moved offshore—particularly to the self-governing British crown dependencies of Gibraltar, Guernsey, and the Isle of Man—to avoid the value-added tax that the UK imposes on marketing spending.

[2]Beyond the US, Japan and Brazil top the list of the next major markets with prospects for official legalization. China is also a large untapped market, but regulators there have been opaque as to whether they will ever lift the current prohibitions. The country is a well-known source of underground offshore activity, funneling billions each year to online betting operations based in Cambodia, the Philippines, and other parts of Southeast Asia.

[3]H2 Gambling Capital 2019 Report.

[4]"DraftKings: Handicapping the First Pick in the Draft," JP Morgan (December 7, 2020); "Gaming's Digital Renaissance Still in Nascent Stage," Goldman Sachs Equity Research (January 26, 2021); "DraftKings: Going Long on US Sports Betting," Alliance Bernstein (January 26, 2021).

DISCLOSURES

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