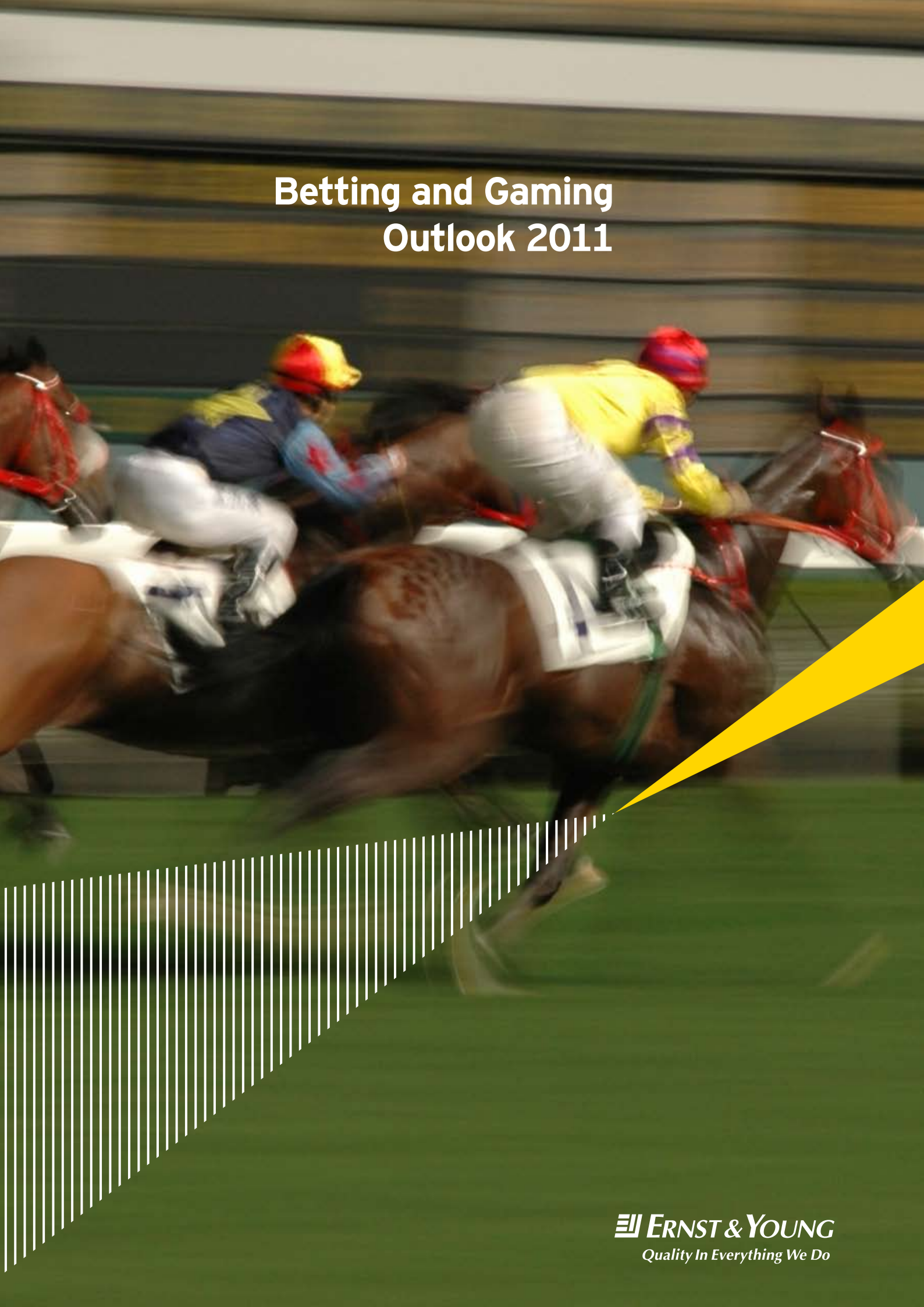


# Betting and Gaming Outlook 2011





## Outlook for the industry

The Betting & Gaming sector to a great extent reflected the UK economy as a whole in 2010, with some recovery experienced from the dark days of 2009, but a return to pre-recession levels of demand and profitability some way off.

Although Gross Domestic Product increased to 1.6% in 2010, compared to a 4.9% fall in 2009, pressure on consumers did not abate. The combination of continuing wage pressure and inflation resulted in real disposable incomes falling by 1.2%, meaning that the increase in consumption in 2010, had to be financed through households dipping into their hard earned savings.

This increase in consumer spending drove a return to net revenue growth in 2010 across the industry, although this is being measured against some particularly weak comparative trading periods. This was driven in the second half of the year by the positive impact of the World Cup, stronger second half football results and an increase in casino player numbers.

The Ernst & Young ITEM club is forecasting the economy to grow by 2.3% in the year ahead, however, despite these encouraging forecasts, household budgets will remain under strain in 2011 as real disposable income is at best flat.

Looking to 2012 and beyond, public spending cuts will maintain the pressure on the labour market and disposable income. Any further recovery therefore needs to be company led, and recent improvements seen in business optimism suggest that business investment will pick up further as world output strengthens. The balance sheets and cash flows of large PLC's in particular are remarkably strong, which should act as a spur to both internal investment and renewed merger and acquisition activity.

“The business outlook continues to improve and the number of profit warnings has moved down to a low level ... However, the domestic economy remains vulnerable as government support is withdrawn and credit remains tight.”

### ITEM Club

#### January 2011 Economic Outlook for Business

In 2011 we expect to see increased 'Competition for growth' across the betting and gaming sectors and we forecast:

- ▶ Limited growth for land-based operators due to subdued consumer spending and cost pressure following the rise in VAT to 20%.
- ▶ Continued improvement in Sportsbook to those with the strongest innovative offers e.g., in play.
- ▶ Further closures of underperforming betting shops, casinos and bingo clubs, as working capital is eroded.
- ▶ An active transactions market, with consolidation continuing in the online sector.

Year	GDP	Domestic demand	Consumer spending
2008	-0.1	-0.2	0.4
2009	-4.9	-4.3	-3.2
2010	1.6	1.5	1.2
2011	2.3	1.5	1.2
2012	2.8	2.2	2
2013	2.9	2.6	2.5

Source: Statistics from the Ernst & Young ITEM CLUB, January 2011



# State of the market – reflections on 2010

Difficult economic conditions continued throughout 2010, although the betting and gaming industry remained more resilient in most areas than the wider economy. The picture was largely positive across much of the sector, with bookmakers, sportsbook, casinos and lottery experiencing positive trading compared to the second half of 2009. Nevertheless, it should be noted that this is a comparison against a very difficult trading period last year and conditions remained challenging.

Although Gross Domestic Product increased by 1.6% in 2010, compared to a 4.9% fall in 2009, pressure on consumers did not abate. The combination of continuing wage pressure and inflation resulted in real disposable incomes falling by 1.2%, meaning that the increase in consumption in 2010 had to be financed through households dipping into their hard earned savings.

Against this backdrop, Bookmakers had a positive second half of 2010, due to the positive impact of the latter stages of the World Cup in July, and comparatively strong sporting results particularly in football. However, the end of the year has been impacted by the bad weather, with 47% of scheduled race meetings cancelled in December including the Kempton King George meeting in late December. The land-based bookmakers also experienced continued growth in gaming machine income in the half-year.

Whilst casino operators continue to face a difficult market due to the impact of the 50% tax rate in large casinos, and the relative weakness in player numbers following the smoking ban, there has been an incremental increase in player numbers compared to 2009 (e.g., Rank plc's Grosvenor Casinos experienced a 14% like-for-like increase in customer visits in the 40 weeks to October 2010).

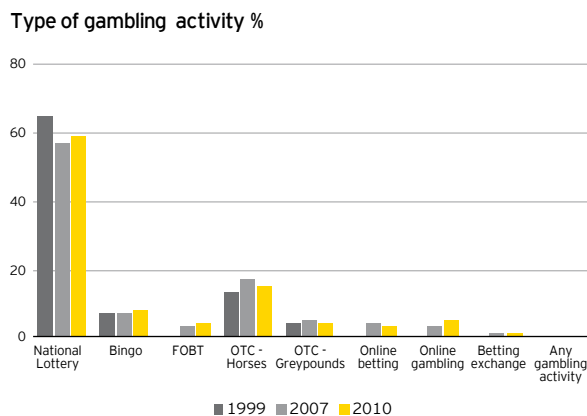
Bricks and mortar bingo showed signs of stabilising in 2010, but adverse weather towards the start and end of 2010 impacted admissions. The reduction in bingo duty from 22% to 20% confirmed in the March 2010 budget benefited profits in the second half of 2010.

Online poker continued a downwards trend in net revenue, driven by continued declines in player numbers. Casino, bingo and poker operators also struggled in July due to the World Cup leading to lower player numbers.

The National Lottery continued to provide an area of hope for people with spend increasing despite the reduction

in disposable income. Camelot's interim results to 25 September 2010 showed the highest sales figures since the commencement of the National Lottery, with like-for-like sales increasing by 4.6% compared to the same period in the 2009.

The 2010 Prevalence Study by the National Centre for Social Research was published in February 2011. This indicated that the proportion of the adult population participating in gambling has increased to 73% compared to that observed in 2007 (68%), demonstrating the increasing penetration of betting and gaming, although this is still led by lottery and associated products such as scratchcards. The study showed two measures of problem gambling, with a small increase compared to 2007 shown by one measure, and a stable level shown by the second measure. The survey also considered the fluctuations in type of gambling activity conducted by those surveyed. The table below presents a comparison of the results of the 1999, 2007 and 2010 surveys, showing that the overall percentage of people taking part in at least one gaming activity has increased from 72% in 1999 to 73% in 2010, having dipped to 68% in 2007.



Source: Gambling Commission, British Gambling Prevalence Survey 2010

2010 has also seen an acceleration in the expected consolidation within the industry, including the announcement of a merger between Bwin and Partygaming merger. The Tote is also up for sale with both existing companies and prominent industry figures backed by private equity groups interested in making the acquisition. Furthermore, we have also seen the IPO of Betfair in the second half of 2010.



# Competing for growth

Ernst & Young has been working closely with businesses across the globe to help them respond to the unprecedented challenges of the financial crisis and changing economy. During September and October 2010 we talked to over 1,400 senior executives to hear their experience, test our thinking and understand more about the actions they are taking to help their companies thrive. We found that:

## Market variation has increased

In the online market there is a variation in tax and regulatory regimes across jurisdictions. This means that the level of returns attainable varies by market, with a business model that is successful in one jurisdiction not necessarily being replicable in another.

This market variation in performance is true for market segments. For example, whilst lottery and bookmakers continued to generate growth in the second half of 2010, the online poker sector continued to experience a decline in margins.

## The market is more volatile

Product life cycles continue to shorten as innovation is increased, especially in the online world. Economic forecasts are being changed and measurements corrected on a quarterly basis. This volatility is placing increased pressure on the need to manage the cost base and to continue to innovate in order to maintain market share. This is visible in the increased value of income generated in-play compared to the more traditional ex ante fixed odds markets by the online bookmakers.

## There is pressure on margins

The online market faces competition driven both by the level of information available on prices offered by competitors and the competing product offered by betting exchanges. This information is also impacting on the margins attainable by the high street bookmakers.

All sectors also face general pressure on margin due to the restricted amount of discretionary spend available to punters due to macro-economic factors. For example, bingo operators are faced with the choice of reducing margins or operating with a reduced prize board (and possible longer term-negative impacts) to reflect a downturn in amount staked.

## Stakeholders are nervous

Capital seems limited and there is caution about the risks that are faced in respect of potential tax and regulatory change across markets. This will directly impact not only margin, but the actual ability of a company to operate in a particular geography or sector.

There are growing demands for greater transparency and improved governance.

- ▶ The land-based betting and gaming companies operate in mature markets. The challenge has been to take out surplus costs and drive operational efficiencies, whilst at the same time driving revenues through maintaining the estate and increasing machine income.
- ▶ The online companies are able to drive revenue innovation and customer service, whilst considering expansion through M&A and entering into new territories.
- ▶ Whilst revenue management and wider strategy can gain market advantage, performance is also influenced by competitor and macro-economic factors.



## How are betting and gaming companies competing for growth?

Our research from this survey and our regular interaction with those in the industry shows that high performing operators are significantly ahead of their competitors in four crucial areas:



### 1 Customer reach

Maximising the potential market opportunity for their product or service

- ▶ Entering into new online and land-based geographical markets
- ▶ Leveraging brands overseas and cross-platform (online to land-based and vice-versa)
- ▶ Innovating and developing new product and increasing customer spend per visit
- ▶ Pursue acquisition or merger strategy to gain access to new markets and gain revenue synergies from cross-selling opportunities

### 2 Operational agility

Improving their ability to deliver effectively in a fast-changing market

- ▶ Enhancing speed of response to regulatory change in existing and emerging markets
- ▶ Innovating new online (e.g., B2B channels, bet-in-play, mobile) and land-based business models
- ▶ Leveraging the operating model to serve different channels, e.g., B2C, B2B, B2G

### 3 Cost competitiveness

Sustaining their economic viability

- ▶ Sustained cost reduction, particularly across retail estates
- ▶ Focusing marketing efforts and managing cost per customer acquisition
- ▶ Pursue acquisition or merger strategy to achieve cost synergies
- ▶ Active Government lobbying to maintain or improve the regulatory and tax position

### 4 Stakeholder confidence

Building stronger relationships with stakeholders

- ▶ Work cohesively as an industry to manage public and media perception of the industry
- ▶ Manage the risk of adverse regulatory change, e.g., by active monitoring of the markets the company is engaged in
- ▶ Offer support to problem gambling through backing of bodies such as the Responsible Gambling Fund



## Opportunity and 2011 (outlook)

The pressure on the economy and resultant disposable income will continue, with the Ernst & Young ITEM club forecasting GDP growth of only 2.3% in 2011. The spending review announced by the Government in October 2010 will contribute to this low level of growth. Consequently, pressure on disposable income will continue to impact the whole sector, particularly due to the increasingly wide player base as the sector has become more socially accepted.

As well as pressure on the top-line and associated gross win, there will be continued cost pressure. The impact of VAT increase to 20% on 4 January 2011 will impact the sector, as most betting and gaming operators cannot recover all the VAT on their overheads. This compounds the effects of the increase from 15% to 17.5% at the start of 2010.

For land-based companies that operate in a more mature market, opportunities for substantial growth in the UK will be limited as long as consumer spend is subdued. We note also that there is no major football tournament in 2011, hence like-for-like sales for bookmakers will be adversely impacted in 2011. The domestic focus is likely to be on cost control, focused upgrading of estates and modernisation of the product. Meanwhile, underperforming small and standalone betting shops, casinos and bingo clubs will continue to close, as the continued period of depressed consumer expenditure drains working capital past sustainable levels. However, there remains an opportunity for growth for those casino and bingo operators that are able to continue to invest in their estate and hence differentiate their offer from their competitors.

The online market continues to be ripe for consolidation. The completion of the Bwin/Partygaming merger was completed in Q1 2011. Also, Paddy Power completed the acquisition of Sportsbet in February 2011. Furthermore, William Hill has entered the US market with the acquisition of three Nevada/Delaware land-based gaming operations, namely American Wagering, Inc., the Club Cal Neva Satellite Race and Sportsbook Division and Brandywine Bookmaking LLC. The Tote disposal is also expected to complete shortly, with Betfred and Martin Broughton's consortium reported as being the final remaining bidders at the time of this publication. We expect this trend to continue, both within the UK and Europe.

As detailed in the review of 2010, the IPO of Betfair completed in the second half of 2010, indicating the markets are open to the right company in the sector. Betfair is in a unique position in the UK market and it is likely that others will seek expansion through acquisition or merger, rather than via IPO. However, we note that there was some negative sentiment in the market, with the Betfair share price trading 23.5% below the IPO price at the end of January 2011.

A further opportunity for extending customer reach and therefore winning the competition for growth is in the regulation of European and other worldwide markets. We have seen Italy and France already open markets with very differing approaches to taxation, and other European countries will follow in 2011. The District of Columbia is the first mover in this regard, with a law passed permitting online poker wagering within the district. However, the US poker market remains an area of uncertainty as the impact of Black Friday, which involved the indictment of eleven senior executives of Pokerstars, Full Tilt and Absolute Poker, continues to be felt. It is likely that the long-term impact of this will be beneficial to those sites that withdrew from the US market on the passing of the UIGEA. Entry into regulated markets in both Europe and the US will only be successful where the right local partner can be identified, and where the tax regime is not punitive for the company involved. We note that certain companies that took the decision to enter the French and Italian markets subsequently withdrew due to the competitive and tax issues faced.

The other key opportunity for growth is in using operational expertise to drive B2B and B2G trade. The regulation in European markets is leading to media and other companies entering the sector to leverage their brand name and customer base. This presents a real opportunity for betting and gaming companies to contribute their software and operational skills which are required by these new entrants to the market.

Overall, we expect the UK economic environment to be challenging for all operators, with land-based businesses unlikely to see significant uplift in revenue and will therefore focus on product innovation and cost control for the year ahead. In contrast, the online market will continue to offer opportunities through transactional activity, geographical expansion and B2B development.



## Other Betting & Gaming thought leadership prepared by Ernst & Young:



### UK Betting and Gaming Update

Monthly newsletter which provides a summary of significant events in the sector.



### UK Betting and Gaming Update

Annual survey evaluating the industry in the major gaming jurisdictions around the world.

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