VALUING INTERNET GAMING ENTERPRISES

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Gambling has been a diversion of mankind since our early beginnings; it is considered to be a harmless entertainment by some, a dastardly vice to be outlawed rigorously by others. Gaming has come a long way, from using shells or stones or beans to today's sophisticated electronics. Based on considerable experience in valuing online enterprises, Corporate Valuation Services Limited of Toronto, Canada, has developed useful valuation techniques for all types of businesses.

The Interactive Gaming Industry

Interactive gaming, is a medium sized segment of the betting business. CryptoLogic Inc., a supplier of Casino Software states turnover was about $5.7 billion in 2003 rising to $7.7 billion this year. For 2005 it should reach $9.8 billion according to gaming analyst Sebastian Sinclair. Operated by around 300 entities, some rather small, there are about 1,800 sites on the Internet offering a variety of casino-oriented games. In addition, punters are served by related entities such as: online lotteries, games of skill such as poker, betting exchanges and financial wagering on indexes or shares.

This Internet activity is both a threat and an opportunity for traditional casinos. Placing bets from a computer at home or in the office offers convenience and potentially a low-cost way for gaming companies to operate. Currently most sites are owned and operated by independents but many large casino enterprises, such as Harrah's have the financial clout and established brands to be competitors when they go online.

The WTO Antigua Ruling

The ability to serve the US market, the world's biggest, online has been hindered by legal restrictions. In March 2004 a World Trade Organization ("WTO"), dispute panel, that heard the case of Antigua and Barbuda vs. the United States, delivered a preliminary decision in favour of the tiny islands. Although it has not yet been published, the panel is reported to have decided that the United States is violating the United Nations General Agreement on Trade and Services ("GATS") by implementing policies that prohibit financial transactions for online gaming services.

This is not a victory for the underdog; the US is not going to immediately declare Internet wagering legal in response to the WTO. Only Congress can change US law, and no one on Capitol Hill is considering legislation to accommodate the WTO.

However, press reports on the decision, which will be appealed, have raised the profile of the industry, something that is never helpful from a lobbying standpoint. To quote Senator Jon Kyl, internet gaming's biggest US foe: "This could demonstrate the need for the United States to act and demonstrate its resolve." His legislation has been on a back-burner for months; now it is possible that the ruling could cause a backlash with some in Congress pushing the Kyl bill to show their disdain of the WTO.

Also in this election year, some commentators may use the issue to try to undermine public support for free trade. A union spokesman might say something like: "Not only do international trade agreements send your job overseas - they will force your children to be allowed to gamble from your living room".

Merger & Acquisition Activity

The industry's diversity is conductive to consolidation. In this process there are more sellers than buyers but little investment banker involvement; most purchasers are either:

- Existing online participants;
- Casino operators; or
- Internet companies

Sellers' Motivations

Among sellers, there are almost as many reasons for a deal as there are transactions; however common motivations include:

- Reducing legal risks, especially if serving the US
- Changed business focus - from a sports book to games of skill
- Cashing out
- Stopping the bleeding (losses)

Buyers' Considerations

In deciding on the price to offer, a buyer should consider:

- Regulatory issues and legal/political climates.
- Use of listed shares, or earnout/milestone payments as alternatives to cash.
- Advantages of using a single software supplier - lower royalties and easier servicing.
- Opportunities of cross selling to participants in other player databases

Recent Transactions

In the last six months internet gaming entities reported sold have included:

- Bet WWTS Sportsbook
- Casino.co
- CentreBet
- Gambling.com
- GoldBet
- Rivals.net
- Sports Acumen
- Sports.com
- Sportsbook.com
- Winneronline.com

Later, in considering Transaction Based Values, we will look in detail at three of these: CentreBet; Sports Acumen, both in Australia and GoldBet of Austria.

Factors to Consider in a Deal

- Consideration - use of listed stocks, or earn-out/milestone payments as alternates to cash
- Advantages of a single software supplier - lower royalties and easier servicing
- Opportunities of cross selling from control of additional player databases
- Regulatory issues
- Legal/Political climate

Gaming Intellectual Property

Unlike traditional firms whose assets, financial and physical, are recorded on their Balance Sheets, most Internet gaming operations have few tangible assets; computer equipment is normally leased and much of the software licensed. Their major assets are mainly intangibles, which are normally unrecorded. They usually comprise some or all of the following:

Marketing

- Brand/Domain Name
- Exclusive Distribution Rights

Customer

- Player Databases

Contractual

- Referral Agreements
- Regulatory Driven Agreements/Contracts

Technology

- Payment System
- Operating Software

All of these are usually valued by a Discounted Cash Flows method, which involves:

- Determining the Cash Flows of the asset or business
- Establishing a discount rate
- Subtracting capital charges for supporting assets
- Determining the present value of the projected Cash Flows

Determining Cash Flows

This requires preparing Financial Projections for five years in the future based on reasonable expectations for:

- Nature and size of the market
- Firm's competitive landscape
- Future revenues
- Profit earning potential (margins)
- Capital investment requirements

Single figure forecasts are not usually appropriate due to the uncertainty of the industry; as the range of possible outcomes may be wide, scenario analyses are essential. In particular, customer retention is difficult to predict; in this respect, non-online data such as from publically reporting casinos, may be helpful.

Other important questions are:

- How many customers can the current infrastructure handle?
- What capital expenditures are needed for expected growth?
- How much extra working capital is needed?
- How long will the business sustain a competitive advantage?
- Are earnings depressed due to marketing, customer acquisition and product development costs (by nature creating intangible assets) being expensed?
- How long will these costs persist and at what level?
- To what extent may competitors force continued expenditures for evolution of the website and customer retention?
- What is the operational gearing (relationship of the fixed to variable costs)?

Value of Customer Databases

The greatest single asset of any gaming enterprise, whether traditional or online, is its customer database. In this section, CVS discusses how this intangible asset can be valued by a Discounted Cash Flows method. To do so, we have created an imaginary enterprise "pickem.nct Limited" in the UK. The process is as follows:

a) Estimate the customer retention rate for existing active accounts;
b) From historic data, establish likely revenue per customer or subscriber, allowing for inflation;
c) Estimate Site-Win Rate to establish revenue;
d) Determine Costs of Operations, including provisions for transaction losses and maintenance (not expansion) levels of selling, general, administrative and customer service expenses to determine the pre-tax earnings from the group;
e) Deduct capital charges for supporting assets, such as: equipment, working capital, brand/domain name, existing technology and other intangible items;

f) Provide for income taxes on the customers' contribution;
g) Establish the annual net contribution of present customers;
h) Establish the present value of expected new customers.

Example

This hypothetical example shows how to value the existing 100,000 customers in the database of pickem.net.

	Projected £'000's				
	2004	**2005**	**2006**	**2007**	**2008**
Retention rate of existing customers	80%	75%	50%	25%	10%
Average number of existing customers ('000)	90	70	45	19	4
Turnover per customer (2% growth)	*£150.00*	*£153.00*	*£156.06*	*£159.18*	*£162.36*
Turnover from existing:customers (£'000)	13,500	10,710	7,023	2,985	670
Site win rate	*10%*	*10%*	*10%*	*10%*	*10%*
Revenue from existing customers	1,350	1,071	702	298	67
Operating costs (40%)	*(540)*	*(428)*	*(281)*	*(119)*	*(27)*
Operating profit	810	643	421	179	40
For supporting assets (33%)	*(267)*	*(212)*	*(139)*	*(59)*	*(13)*
Pre-tax Contribution	543	431	282	120	27
Related tax (36%)	*(195)*	*(155)*	*(102)*	*(43)*	*(10)*
Net contribution	347	276	181	77	17
Present value factor - mid-year at 8%	*0.9615*	*0.8903*	*0.8244*	*0.7633*	*0.7068*
P V of net contribution	334	245	149	59	12
Total present values	799				

At the end of the five year projected period, there would be only 750 active existing customers, so no Terminal Amount is necessary. The total of the present values of the net contributions is £799,000, giving a value of £8.00 per existing customer; if there is a tax shield benefit available due to accelerated write-offs on purchased intangibles, the value could be as high as £9.25 each.

Value of Brand/Domain Names

As well as by the Discounted Cash Flows method, intangible assets are often valued by the Relief from Royalties method. This is based on the fact that if an entity does not own the intangible asset, it would have to pay royalties to use it. The process is as follows:

a) Establish expected total number of customers;
b) Estimate total revenue for products and services that benefit from the Brand/Domain name;
c) Determine an arm's length royalty rate from a search of databases for comparable transactions;
d) Calculate after-tax royalty savings by multiplying estimated revenues by royalty rate and deducting appropriate taxes;

e) Establish present value of after-tax royalty savings using a Discount Rate that reflects the regulatory environment (see next section);

f) If appropriate, apply tax shield benefit from amortization of acquired intangibles.

Now let's look at pickem.net.

	Projected £'000's				
	2004	**2005**	**2006**	**2007**	**2008**
Average customers (2.5% growth)	102,500	105,063	107,689	110,381	113,141
Turnover per customer (2.0% growth)	£150.00	£153.00	£156.06	£159.18	£162.36
Revenue (£'000)	1,538	1,607	1,681	1,757	1,837
Royalty for brand/domain name (11%)	169	177	185	193	202
Related tax (36%)	*(61)*	*(64)*	*(67)*	*(70)*	*(73)*
Net income from brand/domain name	108	113	118	124	129
Present value factor - mid-year at 8%	*0.9615*	*0.8903*	*0.8244*	*0.7633*	*0.7068*
P V of net income	104	101	98	94	91
Total present values	488				

Unlike customers, who cone and go, the Brand/Domain Name has an indeterminate life; therefore we use five years of projections together with a Terminal Amount. For pickem.net, the latter is the present value at 8% of 3% annual growth in the related net income for the next twenty years. As shown in the table, the sum of the present values for the five years 2004 to 2008 is £488,000, while the Terminal Amount is £1,259,000, giving a total value for the Brand/Domain Name of £1,747,000 (rounded to £1,750,000); this could increase to £2,025,000, if a tax shield is available.

Value of Pickem.Net Limited

In 2003, its first profitable year, pickem.net Limited had the following Income Statement and a year-end shareholders' equity (tangible net worth) of £156,000.

	£'000's
Revenues	1,747
Operating costs	(699)
Customer acquisition	(610)
EBITDA *	438
Interest	(20)
Depreciation and amortization	(30)
Pre-tax profit	388
Income tax	(140)
Net income	248

**Earnings Before Interest, Taxes, Depreciation & Amortization*

Net Income Value

With an expected real growth (after 2% inflation) of 2.5%, an appropriate Price/Earnings Ratio would be about 12.5 times, giving a Net Income Value of £3,100,000.

Net Worth/Goodwill Value

The Net Worth/Goodwill Value is very close (-1.5%) at £3,054,000, made up as follows:

	£'000's
Tangible net worth	156
Intangible assets	
Customers	800
Domain name	1,750
Goodwill	
Assembled work force	100
Going concern element	248
Net Worth / Goodwill Value	3,054

This Assembled Workforce is 45% of payroll of £216,000 (40% of Operating Costs) rounded to the closest £10,000. The Going Concern Element is the latest year's net income representing the fact that the entity is a functioning operation.

Discount Rates

The following table sets out indicative Discount Rates for a number of jurisdictions that offer some form of online gaming licenses:

	Rankings				
Indicative Countries	**Business Environment**	**Regulatory Structure**	**Policy Stability**	**Telecom Availability**	**Discount Rate**
Asia Pacific					
Australia*	2	4	3	4	8%
India*	2	3	3	3	12%
New Zealand	3	3	4	4	10%
Philippines	2	3	3	2	25%
South Korea	2	4	4	3	20%
Vietnam	1	3	2	3	35%
Caribbean					
Antigua	4	3	3	4	15%
Grenada	2	2	3	3	25%
Jamaica	2	4	4	3	15%
Curacao	2	2	3	3	20%
St. Kitts & Nevis	2	2	3	2	30%

US Virgin Islands	2	3	3	3	20%
Europe					
Belgium	3	4	4	3	15%
Denmark	2	4	3	3	16%
Germany	2	4	4	4	14%
Iceland	2	4	4	3	18%
Netherlands	3	4	4	4	14%
Russia	2	2	2	2	25%
Sweden	4	3	3	3	14%
United Kingdom*	4	5	5	4	11%
Isle of Man	4	4	5	4	11%
Latin America					
Argentina	2	2	2	3	30%
Brazil*	2	2	3	3	25%
Costa Rica	3	2	2	3	25%
Panama	4	2	3	4	15%
Venezuela	2	3	3	4	20%

Rankings from 1 (low) to 5 (high) from GamblingLicenses.com
** Represents average of locations throughout the country (London is 8%).*

Transaction Based Values

As well as using Discounted Cash Flows methods, valuation analysts also rely on actual transactions in securities of comparable entities or similar intellectual property. This Market Approach is limited by difficulties in obtaining data; often, lack of comparability can also be an issue.

To demonstrate the process Corporate Valuation Services Limited has looked at three recent sports book transactions. Two of them, in Australia, the sale of Sports.Acumen by eBet Limited and of Centrebet by Jupiters to SportOdds took place in the fall of 2003; the other the acquisition of GoldBet by ukbetting plc was in April 2004.

Sports Acumen

The following table sets out the available operating results of Sports Acumen:

	A$ '000			
	6 months to December 2002	**6 months Jun-03**	**Year to Jun-03**	**6 months to December 2003**
Revenues	519	965	1,484	338
Gross profit	392	850	1,242	177
Operating expenses	(522)	(515)	(1,037)	(480)
EBITDA	(130)	335	205	(303)
Depreciation	14	11	25	(29)
Other	(33)	10	(23)	14
Write-offs	-	(535)	(535)	-
Profit before tax	(149)	(179)	(328)	(318)

The reported price was A$2.4 million but it included contingent future payouts, so eBets' actual net receipts were only A$750,000; after costs of A$108,000 this gave an effective transaction price of A$858,000. As the figures for operating results for the six months to December 31, 2003, are those consolidated by eBet they only cover the part of the period up to the sale. Therefore we have used the data for the year to June 30, 2003. At the time of sale, the site had net assets of only A$103,000. The effective transaction price represented the following multiples:

Revenues	**EBITDA**	**Tangible Net Worth**
.058	4.19	8.3

Centrebet

The following table sets out the results of Centrebet for the three fiscal years ending June 30, 2003.

A$'000	**Year Ending June 30**		
	2001	**2002**	**2003**
Turnover			
Total Bets '000	7,573	11,674	15,388
Sports Betting A$000			
Europe	137,968	244,214	268,404
Australasia	71,310	103,268	99,901
Other	42,458	53,524	83,782
Total	251,736	401,006	452,087
Average Bet A$	33.24	34.35	29.38
Revenue			
Gross Win Sports Betting	18,394	28,678	30,025
Win Rate	7.3%	7.2%	6.6%
Other Revenue (excl. Interest)	1,214	1,938	899
Total Operating Revenue	19,608	30,616	30,924
Expenses			
Employee Related	(3,907)	(6,035)	(6,676)
Marketing	(419)	(1,925)	(1,799)
Gaming Taxes	(707)	(1,285)	(1,497)
Information Technology	(575)	(1,023)	(2,381)
Other Operating	(3,530)	(5,489)	(8,640)
Total	(9,138)	(15,757)	(20,993)
EBITDA	10,470	14,859	9,931
Margin	53.4%	48.5%	32.1%
Depreciation	(611)	(1,035)	(2,120)
Amortization	(2,074)	(2,074)	(2,074)
EBIT	7,785	11,750	5,737
Net Interest Income	866	590	425
Pre-Tax Profit	8,651	12,340	6,162
Margin	44.1%	40.3%	19.9%

The consideration, like Sports Acumen paid in cash, was A$46,550,000 compared with an estimated Net Worth of A$2,187,000. The transaction price gave the following multiples.

Revenues	**EBITDA**	**Tangible Net Worth**
1.51	4.68	21.26

GoldBet

A consolidator of British sports book sites, ukbetting plc entered the European market in 2004 by acquiring 51% of Gold Bet Sportsbetting GmbH of Innesbruck Austria for EU 500,000, with further payments, depending on performance, of up to EU 4 million by 2006 for the balance of the Shares. The price was equivalent to an effective purchase price of EU 980,000 for the entity. Revenues were high at EU 8.5 million but EBITDA low at EU 260,000 with a reported Net Worth of EU 246,000. The transaction price gave the following multiples.

Revenues	EBITDA	Tangible Net Worth
.053	3.77	3.99

As a comparison, ukbetting plc, which had a negative EBITDA in 2003, recently had a market capitalization of £37,116,000 or 0.67 times its annualized revenues from continuing operations of £55,172,000 based on the results for the six months to June 30, 2003; those for the full year were not yet available.

Summary

The three sportsbook comparables give the following multiples:

	Revenue	EBITDA	Net Worth
Sports Acumen	0.58	4.19	8.33
CentreBet	1.51	4.68	21.27
GoldBet	0.53	3.77	3.99
Mean	0.87	4.21	11.20
Median	0.58	4.19	8.33

The only meaningful factor is the EBITDA multiple, the others have too large a dispersion to be useful. From it one can say a sportsbook enterprise is worth about 4.2 times EBITDA in a range of 3.8 times to 4.7 times.

Conclusion

Valuing an internet Gaming enterprise is different because of the many uncertainties in the industry. However as set out in this paper, there are established methods to value the two major Intangible Assets Customers' Database and Brand/Domain Name while comparables can also be helpful.