REGULATED ONLINE POKER IN CALIFORNIA: SURVEYING THE OPERATOR OPPORTUNITY

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EXECUTIVE SUMMARY

While California's online poker market is the most attractive of all single-state markets in the United States, its potential is still ultimately constrained by population, the standard dynamics of online poker markets and what is shaping up to be a low-margin environment.

A critical survey of forecasts for California, combined with analysis of comparable markets, pre-regulation consumer activity, and operational conditions unique to California led to a **base case projection** for a mature California online poker market that will:

- Generate **$310mm** in annual revenue
- Generate **$6-$12mm** in annual profits
- Support **three or four** unique, sustainable online poker networks

ABOUT THE AUTHOR

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SIZING THE MARKET FOR CALIFORNIA ONLINE POKER

REVENUE POTENTIAL

As the table below[1] illustrates, there are a wide array of opinions regarding the revenue potential for regulated online poker in California, with a billion-dollar gap between the highest (Capitol Matrix) and lowest (a simple model based on New Jersey's market).

Source	Circa	Year 1 Projection (mm)	Mature Market Projection (mm)
New Jersey model	2015	$125	$204
Nevada model	2015	$151	$210
Academicon	2014	$217	$263
Eilers Research	2014	$222	$273
Deutsche Bank	2015	n/a	$365
Gambling Compliance	2015	$217	$366
Blue Sky	2011	$317	$732
Morgan Stanley	2013	$435	$1189
Capitol Matrix	2013	$729	$1300

The lower-end estimates deserve far greater weight in construction of an aggregate projection.

Academicon's model is built upon (i) a multi-billion hand database of online poker hands[2] and (ii) proprietary data from PokerScout.com. Academicon produced the most accurate projections for the New Jersey online poker market[3], forecasting $38.9mm against the $29mm generated in 2014.

Eilers Research's Adam Krejcik was among the first in the financial research industry to revise his outlook for U.S. regulated online gambling[4] and has a more granular view on the industry than his peers. **Deutsche Bank's Andrew Zarnett** was similarly ahead of the curve in revising his U.S. outlook[5] and engages the industry from a first-hand perspective. Likewise for **GamblingCompliance**, whose estimates – updated in March 2015 – are the freshest of those surveyed.

Nevada and New Jersey are compelling foundations for modeling California's potential simply because they provide the most relevant point of comparison. Admittedly, some challenges faced by New Jersey and Nevada will be more relevant to California than others. For example, payment processing headaches will certainly impact the California online poker experience, while geolocation issues may be less keenly felt.

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1 See Appendix A for more details regarding the projections contained in the table.

2 http://www.academia.edu/2017232/Online_Poker_in_North_America_and_some_more_research_on_online_poker_

3 http://www.academicon.net/en/us-online-poker-market/

4 http://www.onlinepokerreport.com/9762/report-injects-reality-into-igaming-revenue-predictions/

5 http://www.onlinepokerreport.com/12135/zarnett-us-regulated-online-gambling-projections/

But ultimately there are far more similarities than differences between the markets. Critically, the percentage of the California population that played online poker in 2010[6] (.48%) is only 10% greater than the participation rate in New Jersey (.44%), indicating that the inherent appetite for online poker in California may be greater than the appetite in New Jersey, but by a matter of degree - not by an order of magnitude.

Conclusion: A critical survey of available projections, informed by the lesson from New Jersey regarding the optimism endemic to online gambling revenue projections, yields a realistic base case for annual revenue from a mature (Year 5) regulated intrastate California online poker market of **$310mm** (*see Appendix A)*

PROFIT POTENTIAL

EBITDA MARGINS FOR ONLINE POKER

The international market provides a starting point for discussing online poker EBITDA margins. As you see to the right, margins vary dramatically by operator.

Operator	EBITDA margin
Bwin.party	8.5%
888	12%
Rational	38%

Estimates based on company data

Rational's experience is not entirely germane when contemplating California. The company benefits from: (i) economies of scale driven by unparalleled dominance (Rational accounts for over half of the global online poker market), and; (ii) a broad footprint in high-margin markets with low or no regulatory overhead. No parallel for either condition exists within California, meaning the example should be discounted when modeling for California's EBITDA margins.

The nature of the California market must also be considered when contemplating likely EBITDA margins. Regulatory and consumer friction absent from international markets will drive higher-than-average operating costs in California. Products like social casino and daily fantasy could compete with online poker for player mindshare and drive up marketing expenses (an issue that consolidation may eventually solve). And margins will come under unique pressure from the cost of doing business in California[7].

Conclusion: An EBITDA margin range of 8% to 12% *(see Appendix B)* is a reasonable working number for California's online poker market, with two caveats: (i) consolidation could significantly boost margins and; (ii) materially higher margins are possible on the post-maturity (beyond fifth year) horizon.

Taking our base revenue case of $310mm and applying an EBITDA margin of 8-12%[8] yields **projected EBITDA of $25.8mm - $37.2mm** for the total, mature (Year 5) California online poker market.

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[6] *Online Poker in North America: Empirical Evidence on its Complementary Effect on the Offline Gambling Market* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021993

[7] http://www.calchamber.com/cfce/documents/cfce-cost-of-doing-business-in-california.pdf

[8] See Appendix B for assumptions undergirding EBITDA range

TAXES AND FEES IN CALIFORNIA

There are two competing bills in California: **AB 9**[9] and **AB 167**[10] (along with two "shell" bills that contain no details). AB 9 sets a tax rate of 5% of "gross gaming revenue" (GGR), while AB 167 sets a tax rate of 8.5% of GGR. Both bills call for an unspecified annual "regulatory fee" to cover "costs of license oversight, consumer protection, state regulation, problem gambling programs, and other purposes related to this chapter."

First, taxes. New Jersey taxes online GGR at 15% (plus a 2.5% reinvestment tax), Nevada at 6.75%. That suggests room for California's tax rate to edge upward, but not downward, from the currently proposed rates.

Taxes are on GGR, not profit. Both bills provide the same definition of GGR:

> *"[T]he total amount of moneys paid by players to the operator to participate in authorized games before deducting the cost of operating those activities except for fees to marketing affiliates and payment processing fees. [GGR does] not include player account deposits or amounts bet, except to the extent any portion of those bets are retained as fees by the operator, discounts on goods or services, rebates or promotional discounts or stakes provided to players, or revenues from nongaming sources, such as from food, beverages, souvenirs, advertising, clothing, and other nongaming sources."*

In condensed form:

> ***GGR** = All Revenue - Most Marketing Costs - All Payment Processing Costs.*

So what percentage of total revenue will end up being taxable GGR? Analysis of data from Rational Group[11] and 888 Holdings[12] suggests processing costs are 5.5% of revenue. Similar analysis of promotional expenditures implies 38% as a reasonable figure for "deductible" marketing expenses. In the terms of our equation:

> ***GGR** = (100% (all revenue) - 38% (marketing) - 5.5% (processing) = 56.5% of total revenue.*

Next, fees. Neither bill specifies a fee amount. But a few facts suggest the shape of the fee to come. The California DoJ has stressed their need for additional staff for enforcement should online poker be regulated.[13] California Gambling Control Commission (CGCC) representatives have repeatedly stated[14] the need for additional resources to regulate online poker, including potentially expensive technical expertise.

Funding for pursuit of illegal offshore online poker operators could emerge as a political necessity for bill passage. As for responsible gambling funding, New Jersey's current fee assessed to online gambling operators for said purpose is $250,000 (per permit holder, per year).

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[9] http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB9

[10] http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB167

[11] 2013 financial statements for Oldford Group as provided by Amaya as part of acquisition filing on SEDAR

[12] http://hsprod.investis.com/ir/888/pdf/presentation-fy-2014-v2.PDF

[13] http://ggbmagazine.com/issue/vol-14-no-2-february-2015/article/california-controversy

[14] http://www.flopturnriver.com/2015-california-igaming-legislative-symposium-25317

Conclusion: Fees (a fixed cost) will pull at least **$7.65mm** per year from the table (*see Appendix C*). Assuming a tax rate of 8.5% on GGR, taxes will remove **$14.8mm** from our estimated market of $310mm.

Summary: Path from Revenue to Profit

Projections for intrastate California online poker market at maturity

Total Revenue	Expected EBITDA	Less Fees	Less Taxes	Expected Profit
$310mm	$26-$37mm	$7.65mm	$12-$17mm	$6-$12mm

Source: OnlinePokerReport.com

Our projected market-wide EBITDA of **$25.8mm - $37.2mm** is reduced first by fees ($7.65mm[15]) and then by a tax range of $11.9mm - $17.7mm, for a total market-wide annual profit potential of **$6.3mm - $11.8mm**.

A final note: most California operators will rely on partners to provide the underlying technology. Terms will vary from partnership to partnership, but will in all cases result in a material charge, further diminishing the profit potential for the land-based gaming entities that will hold the operational licenses for online poker in California.

THE LAND RUSH PERIOD

The analysis above refers to a mature California online poker market, one emerging four to five years after launch.

But the market immediately following launch could prove substantially more challenging:

- Most forecasts agree that the total market size in the first years will be smaller than the mature market size. A weighted survey of projections suggests a year one market size in the $190mm - $235mm range.
- The license fee ($10mm prepayment of GGR taxes in AB 167) and regulatory fee are fixed, upfront costs.
- Intense competition for players and a need to educate consumers will result in peak marketing costs.
- The freshness of the market means operators will be working with minimum visibility into key metrics like lifetime player value and marketing channel ROI.
- Struggling rooms will have incentive to operate at low or negative margins, triggering promotional price wars that can depress margins across the industry.
- The regulatory learning curve could dampen the market’s performance and extend the maturity horizon.

All online poker sites in New Jersey's regulated market are running at a loss a year and a half after launch (the Borgata has claimed profitability[16], but that's a result of their market-leading casino product). There's little reason to believe California operators will buck that trend during the first year - or two, or three - of offering online poker.

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[15] See Appendix C for details regarding fee calculation.

[16] http://www.onlinepokerreport.com/14368/borgata-online-gambling-returns-profit-for-company/

HOW MANY UNIQUE OPERATORS CAN CALIFORNIA SUPPORT?

POPULATION LIMITS NUMBER OF NETWORKS

While the population of California easily exceeds all other regulated U.S. online poker markets, a ceiling remains on how many unique, sustainable online poker networks the state can support.

It is difficult to operate a sustainable small-scale online poker site. Unlike an online casino or sportsbook, online poker requires a base level of player liquidity to acquire and retain customers. Rooms above that level can offer the desired array of games to players and weather short-term fluctuations; rooms below the level can't replenish lost players and eventually enter a self-reinforcing, terminal cycle of fewer players breeding fewer games.

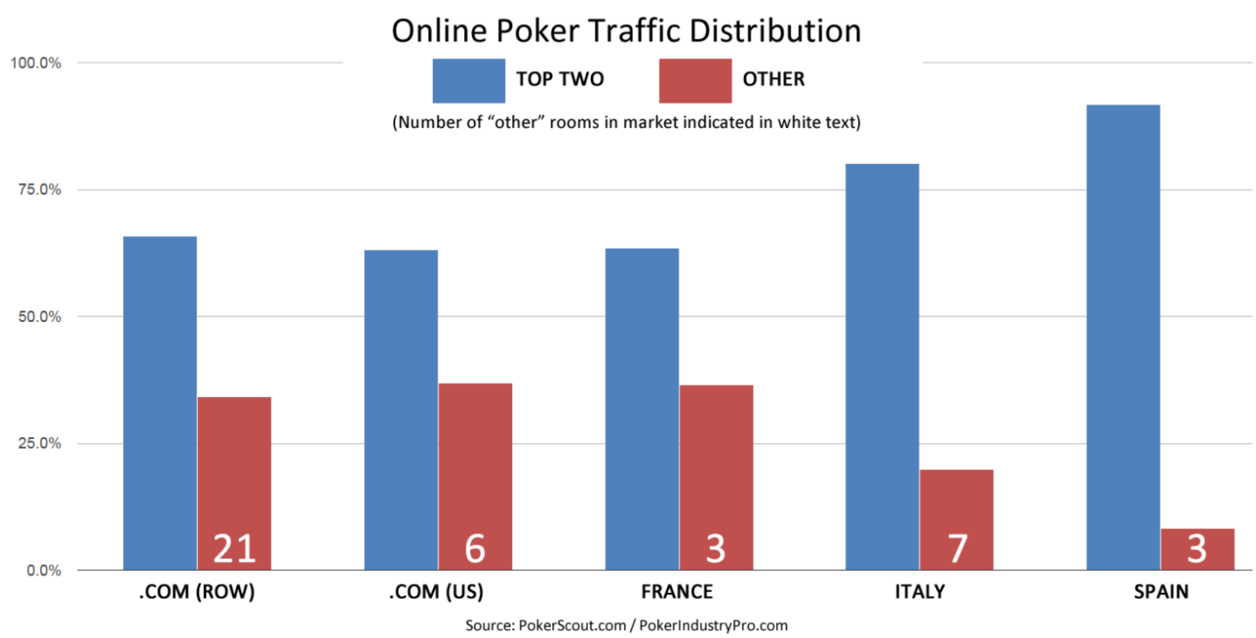
Our research[17] indicates an average U.S. state can support one unique, sustainable online poker network for every 7m residents. New Jersey's experience suggests a number closer to 9m.

Assuming some benefits of scale and that the population is more engaged with poker than average, California could hypothetically support five or six unique, sustainable online poker networks based solely on **population size**.

But population size isn't the only factor that impacts the number of networks a market can support.

MARKET DYNAMICS LIMIT NUMBER OF NETWORKS

Online poker markets inevitably skew toward a top-heavy traffic distribution. In every modern market, the top two operators account for > 60% of traffic. In all but two, the top operator alone accounts for > 50% of total traffic.



Why is this the case?

[17] http://www.onlinepokerreport.com/5834/us-state-online-poker-liquidity/

- **Nothing attracts a crowd like a crowd**. The size of an online poker site is readily apparent to potential customers and is easily advertised. To wit: the massive tournament prize pool guarantee has been one of the most heavily-used promotional tools since the inception of online poker, and remains so today.
- **Players like options**. The greater your liquidity, the greater number of games, stakes, and - most critically - disconnected variants (such as Party Poker's Fast Forward cash games[18] and PokerStars' Spin and Go[19] tournament format) a room can support. That variety keeps active players engaged with the site and acts as a powerful acquisition and reactivation tool.
- **Virtuous cycle**. Much as decreased liquidity begets decreased liquidity, greater liquidity begets greater liquidity. Growth toward optimal liquidity (the most games for the most players at the most times of day) tends to occur exponentially.

How will this play out in California? In a world where traffic was equally distributed, the six networks California's population can hypothetically support would all command 16.5% of the market.

But the standard distribution pattern repeated time and time again in a variety of online poker markets calls for the top two networks to take at least 60% - nearly double the 33% an equal distribution would award. That eliminates the oxygen for our fifth and sixth networks, **leaving us with four**.

And competition will likely drive a further winnowing of the remaining four rooms:

- It's plausible that the bottom two rooms might consolidate to ensure sustainability in the face of the dominance of the top two rooms.
- Or that the number two room will seek to acquire one of the bottom rooms to make a run at the leader (or fend off number three).

Conclusion: Considering population limits and the established dynamic of online poker markets, California will be capable of supporting **three or four unique, sustainable poker networks** at maturity.

FORECASTING WINNERS AND LOSERS

SUPPLY WILL OUTSTRIP DEMAND

There are over 150 potential online poker licensees[20] among California's land-based gaming operators. Of that number, only a few dozen will seriously consider online poker. Many will pass altogether. Others will form cooperatives that feed multiple consumer-facing brands into a single network. But, even accounting for those adjustments, the math of online poker in California appears immutable: there will be more interested operators than the market can support.

[18] http://www.partypoker.com/how-to-play/software/fastforward.html

[19] https://www.pokerstars.com/poker/spin-and-go/

[20] http://www.cgcc.ca.gov/

This might seem counterintuitive given the relatively modest revenue and profit projections offered earlier. Why would so many operators compete for such a relatively thin reward?

Many operators are working from far more aggressive projections. Others are willing to accept a sliver of profit today for the perceived benefit that survival in California offers in future states (e.g., a large player pool for interstate connection, negotiating power with future partners, or smoother entry on the regulatory front). Finally, although they wouldn’t admit it publicly, some operators consider online poker as a step on the road to online casino (or even sports betting) in California.

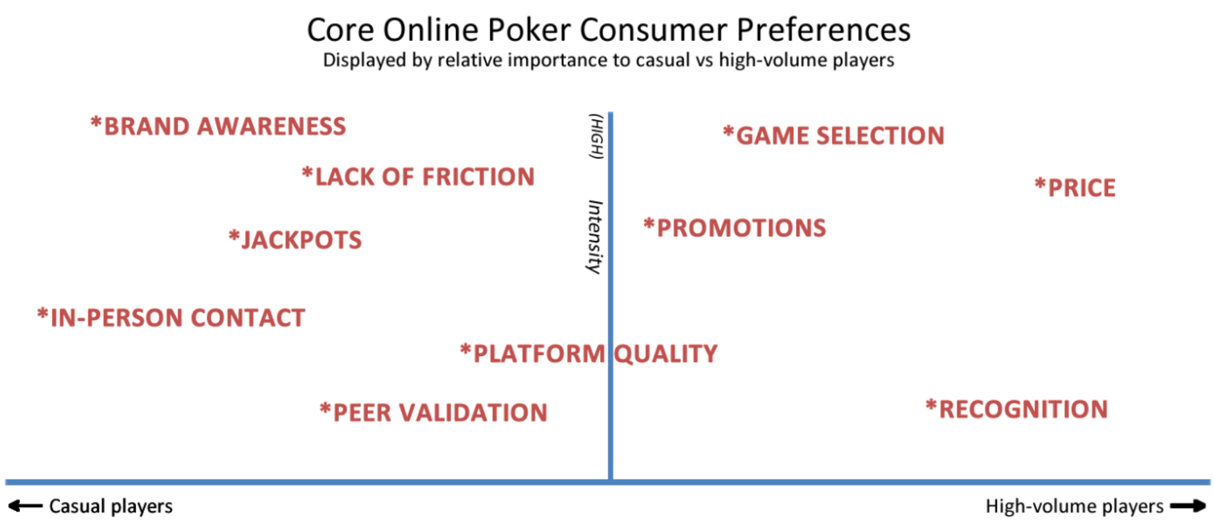
LEADERS WILL BE DETERMINED EARLY ON

Due to the self-perpetuating benefit of superior liquidity, we'll likely see the leaders of California's online poker market established within the first year or two. Once those positions are established, they are uniquely likely to become generally entrenched in terms of top-tier and bottom-tier rooms. Why?

- **California is a closed market**. Without new markets to tap, it's difficult for poker sites to generate the influx of players necessary to upset the balance of power.
- **Incumbent's cost advantage**. The cost of displacing an entrenched winner is greater than the cost of winning in the first place.
- **High price of switching**. The large amount of friction for consumers in the regulated online poker market (e.g., lengthy sign up processes, payment processing issues, tax forms) means players are more likely than average to stick with the room they choose.

CORE CONSUMER PREFERENCES WILL PLAY A CRITICAL ROLE

People choose an online poker room for a variety of reasons. But a handful of top-level preferences exert a disproportionate influence on that decision. Operators that better cater to these preferences will have a higher chance of thriving in California's online poker market.



PERCEIVED VALUE

Customers are price-sensitive (rake), aware of promotional / bonus value, attracted by "jackpot value" and influenced by the potential for recognition (from peers and public).

BRAND EMPATHY

Customers prefer existing brands they know and trust, are heavily influenced by in-person interactions with brand representatives (such as dealers) and are sensitive to their peer group's opinion of a brand.

GAMING JOURNEY

Customers value game selection, are sensitive to the quality and stability of the software platform and react to friction (real or perceived) in the sign up, gameplay and banking processes.

KEY CHARACTERISTICS WILL PREDISPOSE OPERATORS TO SUCCESS

Similarly, a handful of operator characteristics will exert a disproportionate influence on an operator's chances of survival in California's online poker market.

ANCILLARY ADVANTAGES

Operators that can book ancillary value on top of direct profit will be able to justify greater investment, longer profit horizons, and thinner margins.

Such ancillary value sources include things like:

- Synergy with a significant land-based property
- The potential to connect a California base to other player pools
- Broader aspirations in the US market

DEEP POCKETS

More money is an obvious competitive advantage, but the stiff upfront regulatory costs and inevitable front-loaded marketing battle will create a California playing field that uniquely favors the well-funded.

Profit is expected to remain elusive until two, if not three, years into the market for the most successful operators.

The lack of hard data on player values could drive speculative spend that will cause acquisition costs to spiral upward. The “winner-take-most” market likely to emerge in California could have a similar effect on acquisition costs in the near-term.

OPERATIONAL EXPERIENCE

The top-heavy traffic distribution that will emerge rapidly in California, along with the low consumer tolerance for friction, will reward operators that require the least amount of on-the-job learning.

More specifically, experience on the regulatory compliance side (both in terms of a company's general skill and their familiarity with the nuances of California's system) and experience launching in new markets will prove uniquely valuable in California.

CONTEMPLATING CONSOLIDATION

The online poker market in California will provide a reasonable long-term opportunity for a handful of stakeholders. But the short-term story will be one of rapid and violent consolidation.

Following the launch of online poker in California, the majority of operators will be forced into an "all or nothing" strategy whereby they fire the vast majority of their bullets - and budget - in the first years (if not months) of the market's existence. There will be little incentive to hold back in a climate where one or two operators are likely to secure the lion's share of the total profit.

Operators that fail to achieve sustainability will be faced with two choices: shuttering their room entirely, or engaging in a sale / partnership.

A sale or partnership is obviously preferable from a financial point of view, as it provides an avenue for recouping sunk cost. But the nature of the online poker room as an asset complicates that avenue.

The primary value in most California online poker sites that fail to achieve sustainability will be in (i) the room's player base and; (ii) whatever brand equity the site can claim. But surrendering either to another entity could prove costly in various other ways, especially given that some percentage of the pool of potential suitors will be made up of competing operators in the land-based sphere.

Conclusion: Operators must carefully contemplate how plausible exit strategies that involve sale or partnership are, and reconsider financial models that rely on recouping investment from such strategies in the event a room fails to achieve sustainable liquidity.

APPENDICES

A: CALIFORNIA MARKET SIZE PREDICTIONS

SOURCES AND ADDITIONAL NOTES FOR THE PROJECTIONS LISTED

- Academicon: Private report. Summary available here.
- Blue Sky: Report prepared for COPA. Copy available here. Blue Sky did an update to their original report following Black Friday; the table reflects the updated numbers. Blue Sky provided a 10-year horizon to maturity; I took their Year 5 number for a more like-to-like comparison with other projections for "mature" markets.
- Capitol Matrix: Commissioned report. Copy available here.
- Deutsche Bank: Private report. Projections reiterated in April 2015.
- Eilers Research: Private report.
- Gambling Compliance: Private report. Projections circa March 2015.
- Morgan Stanley: Private report.
- New Jersey model: Based on annual run rate of $28.7mm and a population adjustment of 4.35x. Mature market assumes eventual run rate of $3.9mm monthly for NJ.
- Nevada model: Based on annual run rate of $11mm and 14x population adjustment. Mature market assumes eventual run rate of $1.16mm monthly for NV.

Base case projections were taken in all available cases. To the best of my knowledge, all projections assume intrastate only. As an aside, it's unclear how much additional revenue California would actually realize if it were to share liquidity with other states. The chief impact would likely be an expansion of the number of operators the state could support, and not a dramatic rise in total revenue generated.

I arrived at the base case of $310mm in annual revenue via the following weighted average that considered freshness of projection, accuracy of past projections, data set and level of view on industry :

Academicon	Blue Sky	Capitol Matrix	Deutsche Bank	Eilers Research	Gambling Compliance	Morgan Stanley	New Jersey	Nevada
100	4	5	83	83	90	9	75	80

BEAR / BASE / BULL CASES

While I employ the base case as the foundation for estimating profit and the general shape of the market, there are a number of variables at play that could exert an immediate – and powerful – impact on the performance of the regulated online poker market in California.

The following table considers several adjustments to both revenue and EBITDA-impacting factors, discussed briefly below the table. A more comprehensive discussion of the projections is beyond the scope of this analysis.

California Online Poker Market: Bear / Base / Bull

	Bear	Base	Bull
Year 1 Revenue	$178mm	$210mm	$254mm
Year 1 Profit	$ -	$ -	$ -
Year 5 (Mature) Revenue	$278mm	$310mm	$382mm
Year 5 Profit	$5mm	$10mm	$22m

Source: OnlinePokerReport.com

Year 1: The **bear case** is driven largely by the concern that regulators in California will not enjoy the relatively smooth path enjoyed by regulators in New Jersey. California is far more complicated, both in terms of the commercial complexity and the internal regulatory complexity, and any number of forces on either front could result in a sluggishness on the regulatory side that will hamper the market. Other relevant factors include a lack of improvement on the payment processing front and low product quality that keeps players preferring offshore sites, along with the potential for a poorly-constructed bill that somehow inhibits the market.

The **bull case** is driven by an absence of the above and the presence of PokerStars in the market, along with incremental gains from strong land-based tie-ins to online poker and aggressive marketing spend from a robust, motivated set of competitors lacking artificial restraints from legislation or regulation.

Year 5 (Maturity): The **bear case** is driven by a failure of regulated sites to drive unregulated ones out of the California market and a secular decline in consumer interest in poker. On the profit side, a fragmented market populated by operators willing to stay online at a loss could drag down margins industry-wide.

The **bull case** is driven by material progress on the payments front and a balanced competitive ecosystem that produces ongoing, far-reaching marketing efforts but preserves margins, along with product innovation that draws in players from beyond the typical demographic. Finally, the bull case relies on an assumption long-discussed, but never formally or publicly demonstrated, in the online poker industry: that players in California have a materially higher lifetime value (LTV) than the average online poker player.

B: ONLINE POKER EBITDA

I assumed that Rational represented an outlier generated by conditions unlikely to be recreated in the California market. Removing Rational left me with the next two largest publicly-traded online poker operators, Party Poker and 888.

Of the two, only Party breaks out EBITDA margins by product. For poker, those margins were 9.6% in 2014 and 7% in 2013[21]. I took the average of 8.3% as representative.

As for 888, the company reported overall EBITDA margins of 22.1% (2014) and 18.9% (2013)[22]. But as a look at bwin.party’s financials confirm, casino and sport are generally higher-margin products than poker. For example, over 2013-14, bwin.party's EBITDA margin was 22% for sport and 21% for casino. So I feel comfortable assuming 888 is much closer to 10% than 20% on poker.

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[21] https://www.bwinparty.com/Investors/FinancialNews/2015/20150311%202014%20Full%20Year%20Results.aspx

[22] http://hsprod.investis.com/ir/888/pdf/annual-report-2014-v1.pdf

The EBITDA margins of those two operators, combined with some weight for the inevitable startup costs that will be distributed over several years of operation and the high cost of marketing in California, led me to settle on an EBITDA margin range of 8% - 12%. I employed a range because – just as in the international market - some California operators will execute better than others. But that execution will not necessarily translate to a greater share of the market.

C: TAXES AND FEES

The figure of $7.65m in annual fees is an estimate arrived at by assigning the following values to the cost of each item the fee is meant to fund:

- License oversight: Assumed $250,000 in funding for staffing and technology.
- Consumer protection: Assumed $450,000 in funding for unspecified programs.
- State regulation: Assumed $350,000 in funding for staffing and technology.
- Problem gambling programs: Assumed $6.6mm in funding based on New Jersey's level of funding adjusted for population size.

The number does not anticipate any material costs from the "other purposes related to this chapter."

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