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## Gambling on the future of gaming

In Australian folklore there is nothing as bad as a pub with no beer. But ask many in the hospitality industry, and they will tell you it runs a close second to a pub with no gaming machines; and likewise for registered clubs like RSLs and sports venues.

Australia's gambling sector is maturing, and with the announcement that Victoria is discontinuing the Tabcorp/Tattersalls duopoly, the southern state is moving into line with a venue operator system like most of the country. In this article we examine key changes to the Victorian gaming sector and what they mean to hotels, clubs and financiers.



Within Victoria there are 522 licensed hotels and clubs, with 27,500 gaming machines ("pokies"), from which they derive significant revenue.

Over \$2.6 billion was spent gambling on gaming machines in Victoria in 2008; that's after all returns to players and excluding Crown Casino. Based on a 90% average return to players on amounts gambled (State legislation requires no less than 87% is returned to players), that works out to about \$26 billion gambled on pokies in Victorian pubs and clubs last year.

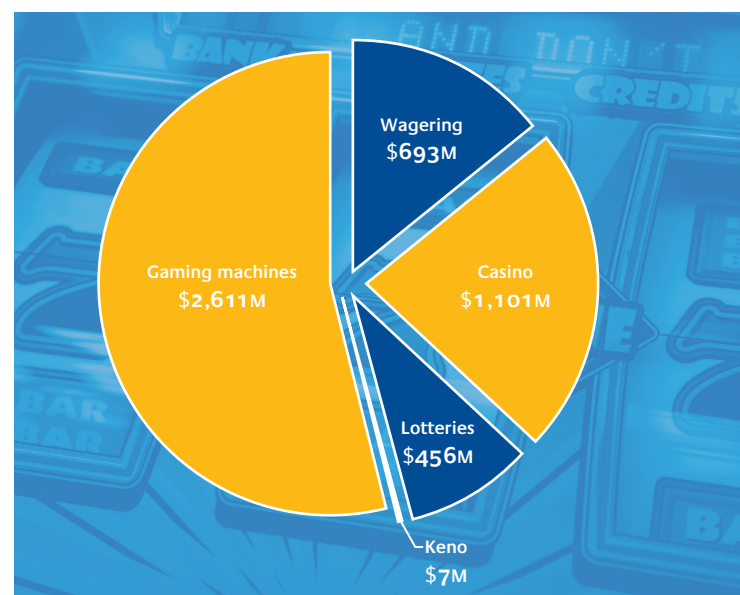
Comparatively, spending on pokies dwarfs other forms of gambling in Victoria, including the casino and wagering.

However within the next few years, the distribution of revenues derived from Victorian gaming machines will undergo significant transformation, as changes announced by the State Government are implemented.

The Government's latest information release and draft bill (announced in December), alleviates

some of the uncertainty surrounding the future of gaming in Victoria, but there is still much for pubs, clubs and their financiers to consider.

Player losses (AUD)



SOURCE: VCGR

These changes stem from the State's decision not to renew the two gaming operator's licences issued to Tattersall's and Tabcorp in the early 90s, which are due to expire in mid 2012.

Instead, licences to own, maintain and operate gaming machines will be allocated directly to hotels and clubs via a competitive bidding process to be completed in early 2010. These licences (referred to as "entitlements") will run for 10 years.

The new gaming machine arrangements will mean that after 2012, operators of pubs and clubs who successfully bid for entitlements will receive a greater proportion of gaming revenue, compared with what they share with Tattersall's and Tabcorp under the existing structure.

Many perceive the new arrangements will be a jackpot for clubs and pubs. But while revenues will increase, considerable capital outlay will be required for the cost of entitlements and machines, plus additional operating costs and taxes will be incurred. Ultimately, there will be winners as well as losers.

Two key issues pubs, clubs and their financiers should be aware of in the Government's latest announcement are the terms of payment for the entitlements and tax structure.

### Terms of payment for entitlements

The proposed breakdown of payment to the government for the cost of entitlements is:

- 1 10% within seven days of entitlement allocation (ie: 10% in early 2010)
- 2 10% in 2012 before commencement of the new arrangements
- 3 The balance of 80% in equal quarterly instalments over four years (the entitlement is for 10 years)
- 4 If payment is not made in accordance with the terms, entitlements will revert to the State

This means that, assuming a 50-machine hotel venue pays \$100,000 per entitlement and

\$20,000 per machine, the venue will need to fund \$2 million before 2012 and before it sees any of the cash flow from its investment.

After 2012, the venue may pay for the balance of the 10-year entitlement within four years, which for some venues is likely to result in negative cash flows until 2016. Again, assuming a 50-machine hotel paying \$100,000 per entitlement, this equates to a commitment to repay a further \$4 million between 2012 and 2016.

There are several consequences for venues and their financiers that may flow from such changes, including:

- By 2012, pubs and clubs will seek funding for gaming machines and the 2 x 10% deposits payable to the Government for the entitlements. It may not be possible for many pubs and clubs to reduce this debt using cash flows before 2016 because of the obligation to the Government to repay the balance of the entitlement cost.
- After 2012, pubs and clubs may need to seek funding from banks to maintain the repayment commitment to the Government for the cost of the entitlements to ensure the venue does not default. Alternatively, the venue may wish to spread the costs of the gaming entitlements over a 10-year cash flow stream rather than the four years proposed by the Government.
- Each venue's performance will need to be closely monitored to ensure that obligations to the State are maintained together with obligations to the bank, because the consequences of losing the gaming entitlements will be catastrophic.

The consequences also depend on how much venues pay for the gaming machine entitlements in 2010. In this regard, Ferrier Hodgson has prepared a financial model for use in assessing the value of gaming machine entitlements. This model is updated as subsequent announcements are made.

## Tax structures

Associated with a gaming venue's ability to pay for entitlements is the new tax structure proposed by the State:

Average monthly revenue per machine	Hotel tax rate	Club tax rate
0 - \$2,666	8.33%	Tax free
\$2,667 - \$12,500	50.83%	42.50%
\$12,501+	58.33%	50.00%

This tax structure will appeal to venues that expect to perform at low levels per machine, but high-performing venues will see around 50% of their monthly revenue being eaten by tax.

Presently, the average revenue per machine across Victoria is just over \$8,000 per month, but can vary significantly from venue to venue.

This means that a hotel deriving about average will pay \$2,975 per month in tax, or an effective rate of 37%. A club will pay \$2,300 per month in tax, which equates to an effective rate of about 28%.

In respect of a venue's return from gaming after tax, high-performing venues that may see benefit in paying a high price to retain gaming machines, will see a large portion of their revenues going to pay tax. This will impact their cash flow and ability to meet debt obligations.

There is plenty for pubs, clubs and their financiers to consider in the new gaming environment, and the amounts involved are considerable for most operators. At the end of the day there will be winners and losers.

The pubs and clubs that lose will not only be those that miss out in the bid for entitlements in 2010, but also the venues that commit to entitlements in 2010 (at all costs) and subsequently fail because they are unable to meet debt and cash flow obligations that follow. This space needs to be watched closely leading up to the competitive bid for entitlements in 2010, and afterwards as costs and capital outlays need to be met. It's not all revenue.

## Where to from here?

- Clubs and pubs need to make decisions about their level of participation in the new gaming machine environment: more machines? Less machines? Present number? None?
- Financiers, clubs and pubs need to review the capacity of the venue to take on debt in 2010 and again in 2012.
- Financiers, clubs and pubs need to consider the amount that the venue should rationally pay for gaming entitlements in 2010.
- Financiers, clubs and pubs need to consider options for the venue in the event insufficient gaming entitlements are acquired
- Ferrier Hodgson has prepared a financial model for use in assessing the value of gaming machine entitlements and is able to assist in decisions regarding venue performance in the new gaming environment.

## Did you know?

- For several years, Colin Gill and Greg Meredith of Ferrier Hodgson Forensics have given expert evidence before the Victorian Commission for Gambling Regulation on gaming revenue derived by venues. They also assist hotels and clubs understand the financial impact of the new gaming environment post 2010.
- George Georges has prepared numerous financial investigations of clubs and hotels over the years and has operated several hotels and clubs on behalf of banks and in an insolvency context.
- Peter Walker has many years experience working with financiers to the NSW hotels sector. He has special knowledge of challenges facing the industry, such as changes to smoking restrictions, licensing legislation, tax, lobbying by social groups and the risks posed to hotel yields.

## Gaming in Victoria – what will change

- Allocation of new gaming machine “entitlements” via a competitive bidding process. All approved venues (existing and new) will be able to participate in the competitive bidding process, expected to be completed in early 2010.
- The new entitlements will enable approved venue operators to possess and operate gaming machines from 2012 for ten years.
- A restriction on the ownership of hotel gaming machine entitlements (not clubs), so that no individual or organisation will be able to own more than 35% of hotel entitlements. Presently, the ALH Group (75% owned by Woolworths) operates more than 35% of hotel gaming machines in Victoria.
- Approved venue operators will be entitled to transfer gaming machine entitlements to other approved venue operators, subject to restrictions to be announced.
- An independent monitoring function will be established to monitor gaming machine transactions in venues.
- Venue operators will be entitled to a greater portion of gross revenue, however capital outlay, taxes and operating expenses will also increase.

## What stays the same

- The VCGR will continue to approve and regulate venue operator licencing. The approvals process will continue to involve a social and economic impact assessment.
- To be eligible to participate in the bidding process, approved venue operators need to hold a venue operator licence. Parties wishing to bid that don’t presently operate gaming machines need to be approved by the VCGR before 2010.
- The numbers of machines outside the Casino will remain fixed at 27,500, split evenly between clubs and hotels and with at least 20% in country Victoria. The venue limit will be maintained at 105 gaming machines and regional caps will also remain.



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