How to Value a Government Lottery?

by Warwick Bartlett and Gordan Zoric, GBGC
– Global Betting & Gaming Consultants

Following the economic crisis of 2007, governments are now in the process of improving their financial health. That process includes the re-evaluation of its policies as regards the gambling markets and, in particular, exploring creative ways to leverage the tremendous asset that is their lottery. Greece has proposed raising € 700 million by changing its gambling laws and opening the market to competition. Spain is following suit with a new regulatory framework that allows for the expansion of gaming, and plans to sell 30% of its stock in Loterias y Apuestas (LAE) to the public, hoping to raise over €7.5 billion. Serbia has announced that it will introduce new online gambling laws with a tax rate of 5% of gross profits. The shareholders of Camelot Group, the operators of the UK National Lottery, decided it was time to cash out and sold their shares last year to the Canadian Ontario Teacher Pension Plan for £400 million (US $650 million). In an effort to improve the financial return, the state of Illinois outsourced the management of its lottery. The bid was won by Northstar Lottery Group, a collaboration between three leading commercial companies: GTECH, Scientific Games, and Energy BBDO. The Illinois Supreme Court just approved that transaction, making the Illinois PMA the closest thing to a "privatization" that the U.S. lottery industry has seen. In this case, the state of Illinois is outsourcing the management of the lottery not for the purpose of generating an immediate cash infusion, but to improve operating performance and income over the next five-year period.

The operative questions as regards to valuing a government lottery include:

• How to align the state's fiscal and public policy agendas with the "best" owner/management model?

• What exactly constitutes "best" when it comes to measuring the performance of a lottery?

• Insofar as the predictive indices that inform a 'present value of future earnings' methodology are difficult to interpret for lottery, how does one determine the monetary value of a lottery?

• How to assess the trade-offs between optimization of long-term income versus immediate infusion of capital, which is a public policy more than a business decision.

These are just a few of the vexing issues that governments encounter as they explore the various options for realigning the capital and/or management structures of their lottery asset. First, let's look at a couple recent examples where valuation was established by virtue of an actual transaction. How was the value for Camelot determined to be £400 million, or New South Wales (bought by Tatts Lotteries in 2010) to be AU $1 billion? These are both leases, not outright purchases. As one private equity analyst who explored the possibility of purchasing Camelot explained to me, the present value of a lease contract should be assessed like that of a bond. Just like a bond, these licences generate income for a pre-determined period of time. A bond exists for a period of time as does a lottery licence. The bond carries a coupon of interest. A lottery once established builds to a peak quickly and maintains that peak producing similar returns year in-year out. At the end of the term the bond is repaid in full by the issuing company or government. The lottery business either loses its licence and the shareholders hold equity in an asset that generates no income and therefore has no value; or a second term is won and the shareholders' equity retains value because the asset retains its income-generating capacity. The value of a lottery company comes down to the income it produces over the term of its contract, whether the operator can win that renewal of its licence, and whether the operator can leverage its expertise into the acquisition of new licenses in different jurisdictions.

The Camelot licence was for ten years. If the UK government had issued a 20-year licence, the bidders would have paid a lot more; and Camelot Group would have commanded a higher selling price when sold last year. But governments prefer short-term licences in case circumstances change with the economics surrounding the gambling market, or public policy objectives change, or because the status or condition of the licence holder may change. Such concerns can be mitigated by contract and conditions attached to the licence, as evidenced in the New South Wales 40-year lease to Tatts Lotteries. With governments' current need for money, we expect longer terms to be negotiated which create more value for the state and enable the operator to invest in building a business with a longer ROI timeline.

Analysts performing conventional business valuations rely on data and the process of benchmarking. Comparing the performance of lotteries is problematic, though. As few lotteries compete with each other in the same jurisdiction, benchmarking one against another creates more questions

than answers. The laws, regulations, tax rates, and level of competition can vary widely from one jurisdiction to another. Public Policy objectives also vary widely, such that the very mission and purpose of the lottery rarely aligns with conventional capitalist business models. Profit maximization is but one of many objectives.

To illustrate our point, we have benchmarked five lotteries. All do a good job, but each lottery is trading in a market where the circumstances differ and impinge upon the performance as measured by conventional benchmarking metrics. Camelot, for instance, operates in the UK, the most competitive gambling market in the world. Horseracing, greyhound racing, betting shops, casinos, bingo, slot machines and Internet gambling both on and off-shore are all competing with Camelot for the players' money. As expected, Camelot's per capita sales are not going to be as high as lotteries that operate in markets with fewer gaming options. On the other hand, Loto-Quebec operates virtually all the gambling in the province, from lotteries to casinos and VLT's, with the exception of horse racing. All lotteries excel at the promotion of responsible gaming, but Loto-Quebec goes even further than most. Loto-Quebec actually reduced the number of VLT's, not because the market wasn't supporting them, but because they deliberately wanted to manage demand by reducing supply. So, in the case of Loto-Quebec, it would be a mistake to interpret a negative CAGR as poor performance since this was in fact its public policy and therefore business objective.

Revenue Growth 2006-2010 (CAGR: Compound Annual Growth)

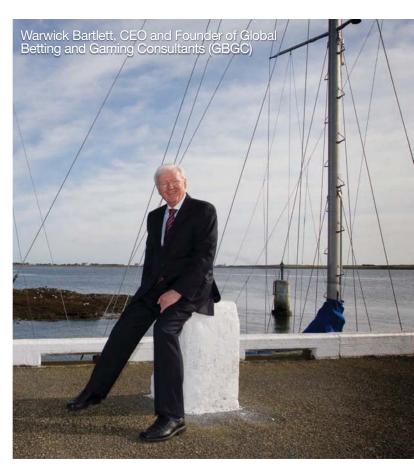|	CAGR 2006-2010
NY State Lottery	4.5%
Florida Lottery	2.4%
Loto Quebec	-7%
Camelot Group Plc	2.7%
FDJ	3.4%

Source: GBGC Analysis

The NY State Lottery tops the bill with a CAGR of 4.5% over five years. But the New York State Lottery is one of only two lotteries included in the analysis that operates VLT's, and it has reaped the benefit. In 2010 they had 12,500 VLTs in operation. NYSL takes 47% of the net win from the state's racinos. NYSL is a great example of how smart enabling legislation combined with a favourable competitive landscape can produce enviable financial results.

Government Transfers 2006-2010

	Transfers Total (US$m)	Transfers/Gross Revenues	CAGR 2007-2010
NY State Lottery	12328.7	33.3%	4.9%
Florida Lottery	6306.0	31.4%	0.4%
Loto Quebec	7070.5	37.8%	-4.5%
Camelot Group Plc *	15232.5	38.2%	1.4%
FDJ	17333.8	27.0%	0.0%

Source: GBGC Analysis
* Includes National and Olympic Lottery Distribution Funds + Lottery Duty

Warwick Bartlett, CEO and Founder of Global Betting and Gaming Consultants (GBGC)

Lotteries have been granted monopoly status for two primary reasons. One, to provide government and charitable enterprises with funding for good causes. Two, to minimize social costs and prudently manage the growth of the gambling industry. As regards to the objective of maximizing transfers to its beneficiary, La Francaise Des Jeux tops the list, with Camelot coming in at a close second. However, FDJ's transfers as a percentage of gross revenues are much lower than Camelot's. It is likely that Camelot's total transfers would be higher were it given the flexibility to increase prize payout percentages (that would be made possible by public policy that focused more on the total transfers rather than transfers as a percentage of revenue). Of course, total transfers are determined mostly by top-line revenues which are much lower for the lower population markets of the Florida and Loto-Quebec lotteries. The NY Lottery growth in transfers coincides with its growth in top-line revenue, which reflects thoughtful business strategy.

Marketing Efficiency 2006-2010

	Advertising Spend Total (US$m)	Advertising/Revenue
NY State Lottery	407.62	1.102%
Florida Lottery	172.03	0.856%
Loto Quebec *	118.92	1.415%
Camelot Group Plc	562.94	1.238%
FDJ	559.02	0.851%

Source: GBGC Analysis
* Advertising spend only for lotteries and sports betting games

There are different ways to interpret the advertising/revenue ratio as a measure of performance. From one perspective, Camelot deserves credit for optimal ad' spend performance because of the highly competitive market in which it operates. Loto-Quebec invests a higher percentage of revenue in marketing, but this is a reflection of the regressive economy of scale competing in a market with a population of only 7.9 million compared to France and the UK populations of over 60 million.

Revenue per Capita (US$) in 2009

	Revenue per Capita	Revenue per Capita Adjusted for Wealth
NY State Lottery	392.0	290.6
Florida Lottery	212.8	196.0
Loto Quebec	432.5	511.3
Camelot Group Plc	136.5	154.5
FDJ	224.1	267.9

Sources: World Bank, Board of Trade of Metropolitan Montreal, US Department of Commerce, US Census Bureau, GBGC Analysis
Note: Revenue per capita adjusted for wealth was calculated using GNI per capita.

Looking at revenue per capita, Loto-Quebec is the leader. Loto-Quebec comes top even more so when we adjust the revenues using gross national income per capita. Camelot's less admirable metric reflects the UK's dismal economy and competition in the market place. On the other hand, Florida has the double challenge of a very low ad' spend per cap and a high percentage of revenue transfer, so it is not surprising that it's per cap sales are lower.

Again, we see that results as measured by conventional indices do not accurately reflect performance as measured against the mission and objectives of the lottery stakeholders. We need to find ways to integrate these other factors into the value-assessment model.

Revenue per employee in 2010

	Revenues (US$m)	Number of employees	Revenue per Employee (US$m)
NY State Lottery	7818.3	350	22.3
Florida Lottery	3907.0	440	8.9
Loto Quebec	1788.3	250	7.2
Camelot Group Plc	8534.4	750	11.4
FDJ	13974.8	1065	13.1

Source: GBGC Analysis
Note: Camelot and Florida revenues and employees only for lottery games, Lotto Quebec and FDJ for lottery and sports betting games, and NY Lottery for lottery games and VLTs

In conventional businesses, revenue per employee is normally a good measure of efficiency. That's not necessarily so in the case of lotteries. The revenue per employee ratio is high where the lottery outsources a large number of business functions and lower where the lottery performs those functions in-house. Both are perfectly valid approaches to running the business. Loto–Quebec's business model includes control of more business functions which results in lower suppliers costs and more in-house control of quality. New York State Lottery operates a model in which more of the functions are outsourced and the result is a super-high revenue per employee of $22.3m.

So who is the winner on this crazy benchmarking metric? The reality is they all are. They all return something around 1/3 of revenues to the state, far more than any other sector in the gaming and gambling industry. So the real winner is the Good Causes funded by government lotteries.

The reality also is that government lotteries have a more complex set of business and public policy objectives, along with constraints that typical businesses do not face. We still need to build models that enable an assessment of lottery performance. But those models need to incorporate all these mitigating factors if we are to arrive at an accurate picture of lottery performance and value. ◆