

Squeezing the Bookie: A Look at Online Gambling



High Technology Entrepreneurship and Strategy

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INTRODUCTION

In this paper we intend to look at the traditional structure of the fixed-odds betting industry in the UK. We outline the drivers of competition in the bookmaking industry to establish why the industry has come to be dominated by a few large players and identify what has made these firms more competitive. In particular, we analyze the competitive strengths of one of the key players, William Hill. We then look at the disruptive effects of the internet on this industry and examine how well the incumbents have reacted to two different types of innovation. We first establish how capabilities that made the incumbents competitive in their traditional channels gave them a competitive advantage in the new channel. We then look at a second disruptive model which manages to negate the incumbents' existing advantages and is likely to prove more of a challenge to the incumbents in the long run.

I. THE BOOKMAKING INDUSTRY

Since the 1960s, bookmaking¹ in the UK has been strictly regulated by legislation contained in the Betting, Gaming and Lotteries Act 1963. Initially the industry was characterized by a large number of small, independent operators. Because there are economies of scale in the traditional bookmaking business, the industry has consolidated over time. The end result has been the emergence in the UK market of the "Big Three" players: William Hill, Ladbrokes and Coral

Around GBP 42 billion was wagered in the UK during 1998 generating gross profits (known as "gross win") of GBP 7.3m². Of these amounts, betting generated approximately 20% of turnover and 25% of the gross win. A national survey in 2000 found that 72% of the UK adult population had gambled in the preceding year and 9% had placed a fixed-odds bet³.

Product Offerings in the UK

Gambling in the UK is characterized by two types of betting:

Fixed-odds

This is the traditional form of betting where odds are offered against a certain outcome. For example, someone could place a fixed-odd bet on a horse, Nag's Nose, at 7 to 1. Here a "punter" (someone placing a bet) might bet 1 pound and

¹ Bookmaking refers to the practice of "running a book" i.e. accepting bets at fixed-odds on the outcomes of events.

² The Gambling Review Report (A.K.A. The Budd Report), 2001.

³ National Centre for Social Research – Prevalence Survey 2000.

would win 7 back if Nag's Nose won. The odds are decided by a bookmaker and the punter has only the option of whether or not to place the bet at the odds offered.

Spread betting

This is where a bet is placed that an outcome will be higher or lower than a given number. The winnings or losses are dependent on how much higher or lower the outcome is. For example in a cricket spread bet, the number of runs to be scored by Nasser Hussein might be quoted at 22-25. If the punter believes that Hussein will score more than the quote he can buy runs above 25, otherwise he can sell at 22. If the punter buys runs at GBP 10 per run at 25 and Hussein scores 75, he will have won GBP 500 $((75 - 25) \times 10)$, if however Hussein is out for a "duck" (0 runs), he will lose GBP 250 $((0 - 25) \times 10)$. If he had sold runs at 22 for GBP 10 each he would have lost GBP 530 if Hussein scored 75 $((75 - 22) \times 10)$, but won GBP 220 $((0 - 22) \times 10)$ if he was out for a "duck".

A particular variant of spread betting is index betting or "Contracts For a Difference". These are spread bets on financial indices such as the FTSE100 or on individual stocks. They have also seen a huge surge in popularity due to a loophole in UK taxation which allows for betting winnings to be paid tax-free. Because they qualify as bets, they can be used as tax-efficient derivatives to enhance equity trading.

In our analysis we concentrate on how the advent of the internet affected the competitive dynamics and composition of the UK fixed-odds betting market only.

Channels

The major channels through which bets are placed are Licensed Betting Offices ("LBOs"), telephone call centers and (more recently) online.

Licensed Betting Offices

A Licensed Betting Office is a specialist retail store where punters can place their bets. Most of them have TV screens where customers can follow sporting events (horse racing, greyhound, football, etc.) on which bets can be placed. Betting shops have been the traditional off-course bookmaker operations and are still prevalent and profitable today. The major key companies (and number of LBOs) in the industry are: Ladbrokes (1,880), William Hill (1,536), Coral (870), Stanley

(570) and the Tote (400)⁴. Independents account for around 3,000 shops. There are economies of scale in operating LBOs and, as the market leaders have gained market share, they have become increasingly competitive versus small operators. Simultaneously, competition from alternative betting channels has increased. Many of these smaller operators have therefore been forced to either sell out or to close. This consolidation has reduced the number of LBOs operating in the UK from 9,400 in 1993 to 8,300 in 2001.

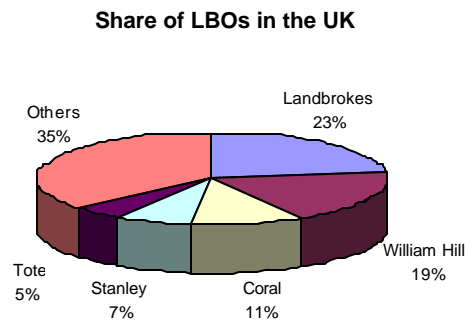


Figure 1. Bookmakers' percentage share by number of LBOs in the UK.

Telephone

Telephone betting has been around for over half a century. Indeed, William Hill started as a telephone bookmaker in 1934. In 2002 telephone betting accounted for 9.6% of the company's turnover and 14.6% of gross win. The drivers of competition in telephone betting are:

- Availability of operators when punters wish to place a bet. William Hill has the capacity to handle 640 simultaneous calls between two call centres and has queuing capacity for a further 700.
- Speed, efficiency and dependability of service. Punters want their bet to be placed quickly and without doubt.

William Hill has innovated in the field of telephone betting for example by being the first to introduce a freephone number and to accept debit cards in 1991. This history of pioneering new offerings has won them a leading position in this channel with an estimated market share of 40% by turnover.

Internet

⁴ William Hill Listing Particulars, 2001.

The market for online gaming has been dependent on the adoption and penetration of internet access. It offers the advantage of easy odds updates and comparisons in the punter's own time, in the comfort of his own home/office. The online market is split between casinos and sports/events betting. Within the latter the market is subdivided along the different types of bets offered: fixed-odds, spread bets and matched bets.

The online betting market initially developed as a result of a tax loophole which allowed off-shore bets to circumvent the 9% tax levied on UK bets. However, the early tax advantage of new entrants created to capitalize on the loophole was fairly quickly neutralized by the incumbents' responses of opening their own off-shore, tax-exempt operations. The UK government changed the tax legislation in 2001 in favor of a gross profits tax in order to reverse the flight of UK bets from the mainland and to preserve this important source of tax revenues. The incumbents have now repatriated most of their operations and dominate the UK online market.

Channel demographics

The traditional customer of the LBOs tends to be middle-aged and in a lower socio-economic band. In Ladbrokes' LBOs, 81% of regular customers are male in the lower band C2DE. 35% of customers place bets at least once a week and they account for 97.5% of LBO turnover⁵.

For regular, serious gamblers, the preferred channel has been the telephone call centers. The "Big Three" operators are finding the telephone to be a cost effective means of accepting stakes, whilst internet operators have found call centers to be a high cost option and have tried to migrate telephone customers to transact online.

The internet has proven popular with males in higher socio-economic classifications who may not have traditionally been gamblers. Their bets tend to be less frequent, but of higher average value. The internet has therefore helped to grow the total market rather than just cannibalize existing business.

⁵ Competition Commission Report on Ladbroke's proposed acquisition of Coral, 1996.

Key Developments in Recent Years

Introduction of the National Lottery, 1994

The introduction of the lottery caused a temporary slump in the revenue growth of the traditional bookmakers. However, once the novelty value wore off the amount wagered weekly on the lottery plateaued. Over the longer term the National Lottery has brought a sense of legitimacy to gambling and helped to popularize it as a socially acceptable leisure activity.

Change in taxation regime , 2001

Before October 2001 the government levied a 6.75% betting duty to all off-course bets placed in the UK, which was charged at 9% to punters to cover administrative costs and raise funds for the Jockey Club. This was replaced by a 15% tax on gross win, allowing mainland operators to compete effectively against off-shore betting companies that had been winning business in the UK via the telephone and internet.

Budd Report and the Government White Paper, 2002

The report, commissioned by the British government, recommended the relaxation of the current strict regulation on gaming activities. In particular, it proposed the easing of advertising restrictions and the introduction of a code of practice. It was intended to ensure the UK a leading position in the industry whilst preserving protection where necessary against gambling by addicts and minors.

Basis of Competition

Competition among bookmakers is driven by four main factors: Brand and Advertising, Channel Reach, Pricing and Event Risk Management.

Brand and Advertising

Leisure gamblers are attracted to those firms with high brand recognition such as William Hill and Ladbrokes. A strong brand offers the security that odds will be honest and that the bookmaker will honor successful bets. Continual advertising expenditure is needed to maintain a brand's awareness and to ensure that punters have opening odds, telephone numbers and web addresses available in media such as newspapers, should they wish to place a wager.

Channels

Different types of customers prefer different channels for betting and in order to reach these different types, companies need to offer them whichever channel they wish to use. Most people who prefer LBOs have a 'local', often the nearest shop, where they go regularly. Because of this oligopolistic element of the LBO market, the Big Three have a major advantage in offering services to these clients because of their extensive networks of shops that cover the major towns and cities in the UK. Other operators have to accept that they cannot target the entire market and concentrate on clients who use other channels.

Pricing (Odds)

In fixed-odds gambling, the price is essentially the odds that the bookmaker offers to the punter for an event outcome. Many gamblers shop around for the best odds, therefore bookmakers attempt to attract clients with the most attractive odds that will still give them a reasonable return.

Risk Management

The strong competitive pricing dynamics in the industry result in bookmakers offering similar odds. However in some events bookmakers may offer slightly different odds from each other resulting in skewed exposures to particular events. Normally a bookmaker would hope to secure a guaranteed gross win from an individual event, however, this is not always possible so it is important that pricing is sufficiently accurate (statistically) to ensure a decent return over several events. Bookmakers have specialist teams and risk management systems to monitor carefully their portfolio exposures. William Hill for example employs sixteen odds compilers and seven on-line international risk managers, as well as outside consultants.

A Look at William Hill

William Hill started as a telephone bookmaker in 1934 and by 1988 the company had grown to become the second largest bookmaker in the UK, with 900 shops and 25,000 credit account customers. Grand Metropolitan acquired the company that year to merge with its subsidiary, Mecca Bookmakers. The merged company was taken over the following year by the Brent Walker Group before being sold to Nomura Principle finance in 1997. After a secondary buy-out, the company was eventually listed on the London Stock Exchange in 2002.

The company has been innovative in its attempts to win business. For example when the National Lottery was introduced, the company came up with a numbers game based on choosing numbers between 1 and 49, just like in the lottery.

The advent of the internet and its increase prevalence permitted certain operators to take advantage of tax benefits from operating outside the UK. The most famous example was Victor Chandler who moved his bookmaking business to Gibraltar in 1999. This successful business model was imitated by other new gaming dot.com entrants. William Hill responded by opening a telephone betting operation in the Isle of Man. However, this operation was only tax exempt for non-UK residents and the company subsequently opened an operation in Antigua to provide tax free betting to UK residents. These telephonic operations were complemented by an internet web site offering the same benefits to users who preferred the online channel. The company accepted its first internet bet in 1998. In 2002, the telephone channel generated GBP 54.9 millions in gross wins and netting a trading profit of GBP 20.5 millions.

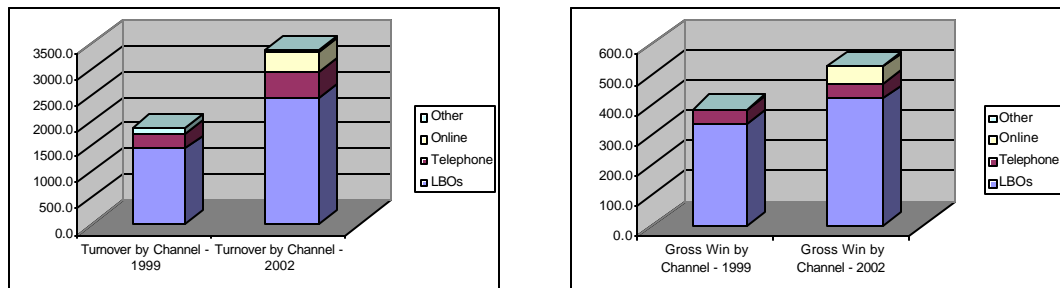


Figure 2. William Hill turnover and gross win by channel. Source: William Hill Annual Report and Accounts 2002

Incumbent Strengths and Weaknesses

William Hill benefits from exhibiting strength in each driver of competition described above:

- Brand and advertising – an established and recognized brand in the UK. Brand awareness is especially important for the online business where trust is a key requirement of customers. The company can add their web address to all promotions enjoying significant scale economies in their marketing efforts
- Channel reach – a strong position in the principal betting channels in the UK. Moreover William Hill is increasing its international reach via its internet web site.

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- Economies of scale – The large LBO estate gives William Hill a competitive advantage in terms of brand recognition and by allowing central fixed costs to be spread across a large number of betting shops.
 - Proprietary knowledge/skills – With their long history of bookmaking, William Hill has developed advanced risk pricing and management systems that allow them to maximize the likelihood of event bets proving profitable. William Hill's strength in risk management stems from:
 - Industry knowledge – Vast experience and knowledge of the industry, individual races and participants.
 - Warm sources – Bets placed by customers known to be event insiders are closely monitored and may cause odds to be adjusted down.
 - Pattern monitoring – Betting patterns via the different channels are compiled to monitor the potential liability of the events.
 - Risk Diversification – because of its size and number of events that the company covers, William Hill is able to ensure more stable returns.
 - Cost Structure – The incumbents have very high fixed costs. Presently this is not a major concern as the LBOs, which are a significant driver of these costs, are very profitable. If LBO business was to suffer due to new entrants these branch networks would change from assets into liabilities.

II. THE FIRST CHALLENGE: CHANNEL INNOVATION

The internet is an interesting channel for distribution of bookmaking services. Gambling operators become unbounded by geographic constraints and enter a market with global reach. Anyone can play from anywhere (though this may be illegal) with the only requirements being credit cards and internet connections. Only 8 of the world's 300⁶ or so countries have bookmaker shops and vast areas of the world (Asia, South America) are literally virgin territory. There is no longer a need to be in proximity to a bookmaker and customers that had not had the opportunity to gamble before can now enter the market. One can see how market opportunities would increase phenomenally.

Additionally, the ever widening media coverage of major international sport events is boosting worldwide interest in these events and subsequently the interest in placing wagers on the outcomes. Consequently, the sport wagering market is growing strongly. Customers demand not only more betting options in

⁶ Annual Report 2000, Sportingbet Plc www.sportingbet.com .

terms of the number of sports but also want more modalities of bets (one to one, fantasy games, etc).

The internet opportunity can be further characterized as follows:

Wider betting opportunities - The internet makes it possible to bet on many more events and with operators all over the world. More betting modalities are available. Technological developments make customizing possible: more currencies are accepted, different methods of paying are available .

Convenience - A person does not have to leave his or her home to wager. He can wager from wherever he is: at home, in the office or even on holiday. It becomes possible to wager at any time of the day, every day of the year.

Anonymity - Many gamblers may wish to remain anonymous even from the gaming operator⁷. Online gambling allows for this possibility.

Tax Advantage - Possibility of acquiring gambling licenses in countries where no taxes are paid both for the operators and the players.

Lower Barriers to Entry - Internet sports wagering sites do not need to be as technically advanced as traditional horseracing sites. The interaction between the sports wagering site and the home user is simple. The site only needs to provide information on those games or events on which it will accept wagers. In turn, the player chooses the wager that he or she wishes to place and the amount of the wager. Because of the wide availability of sports broadcasts via television and cable, Internet sites do not have to provide "live" video feeds of the sporting events.

Diversification - The industry is "customer intense" with huge advantages for economies of scale both in terms of hedging risk and lowering costs. Also, the wide variety of sports that may economically be offered by an online operator can reduce operators' dependence on any single sport and lower seasonality effects. For example, Betinternet states in its prospectus: the objective is to "reduce the company's reliance on both the Irish market and on horse racing in favor of other sports perceived to have international appeal such as soccer, American and Gaelic

⁷ Anthony Cabot, Can Gambling Work on the Internet? Chapter 7 of Internet Gambling Report II, Lionel Sawyer and Collins 2001.

football... The underlying objective is to reduce the effect of seasonal variations relating to particular sport.”

Data Mining - A person wishing to gamble over the Internet must first register with the gaming operator and provide personal information that is necessary to establish some form of funds transfer, such as a credit card or direct bank transfer. Although this can be a drawback for anonymity, it provides operators with extremely valuable information about customers’ habits which can be used to reduce risks and offer a more customized service.

The Online Gambling Market

Europeans bet more than US\$3.7 billion online in 2002 versus US\$139 billion in traditional venues. This figure is projected to reach US\$15.5 billion by 2005⁸. The expected growth of the online gambling industry is therefore phenomenal and those firms that capitalize on this growth stand to make serious amounts of money.

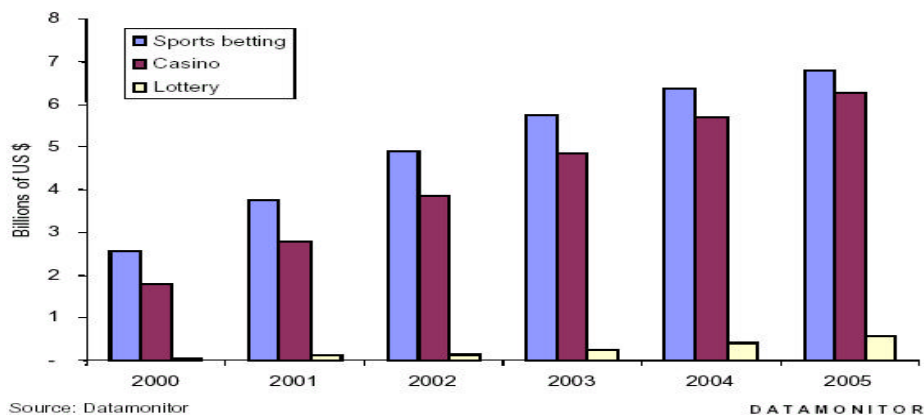


Figure 3. Forecasted online gambling revenues by genre 2000-2005.

Although there is no consensus about the figures, one of the estimates of the market for online gambling is US\$6,300m⁹. In the UK alone, the 2001 annual gambling turnover was £638 bn. Of this turnover £21 bn came from online gambling and of these online wagers, it was estimated that £2 bn came from racing and £9 bn from sport betting in general.

⁸ Online Gambling in Western Europe, Schema (www.schema.co.uk).

⁹ Mark Balestra, Sebastian Sinclair, Wagering on the Internet, River City Group 2002.

Millions of Gamblers
Source: DataMonitor

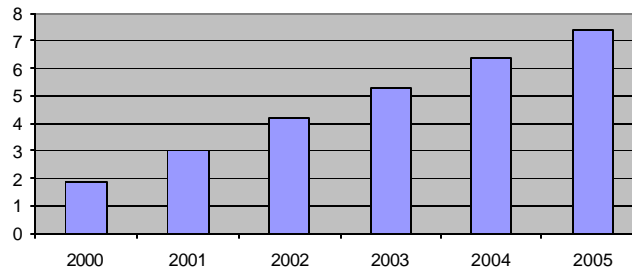


Figure 4. Forecasted figures for number of online gamblers in the world.

Currently, the biggest online betting market is the United States but Asia is expected to take the lead in a few years time, particularly due to growth in the Japanese gambling industry¹⁰. The European market is rising as major UK bookmakers are accepting increasing numbers of bets online, thanks to their established reputations and reliability.

Online betting is one of the fastest-growing businesses on the Net. According to merchant bank Bear Stearns the amount of sites offering gambling services had more than doubled in 2001, and there were more than 1,400 online gambling related sites by 2002. The River city group found that 87 publicly traded companies worldwide had an interest in internet gambling operations, either as operators, software developers, marketing firms or e-commerce providers.

Moreover, internet advertising has benefited from increased promotion of online gambling ventures. During 2002, the number of online campaigns for the gambling sector increased by 101%¹¹. The success of online gambling in the UK has enabled these websites to further benefit from their high traffic by carrying advertising from other sites. The total number of campaigns running on gambling sites surged by 109% during 2002, and the number of advertisers using gambling sites to market their products or services grew by 151% over the same period.

Online gambling is helping drive growth of new media channels. By 2005, nearly a third of e-betting is expected to take place via the internet or interactive TV. Wireless operators are hoping to drive demand for mobile wagering to help recoup some of their extraordinary investments in 3G networks.

¹⁰ Betinternet.com listing particulars 2000.

¹¹ LemonAd research, Porter, Bryan Online Ads in gambling sector increases by 101%.

Major Obstacles

Bookmaking tends to be a highly regulated industry with different regulations in each country, making it difficult for gambling companies to operate globally. Moreover, customers' habits are often completely different between countries. The two major obstacles faced by online gambling are fraud and regulation.

Fraud - In the U.S., banks and credit-card companies increasingly refuse to process operations from e-casinos and Mastercard recently disclosed that e-gambling was its primary source of fraudulent transactions. Dealing outside of a regulated region, consumers have little protection against unscrupulous companies that may just take their money and not pay out.

Regulation - In most countries online gambling is banned. Britain's legislation has the most liberal approach, providing the "best possible environment for online gambling companies in the world". On the other hand, in the United States the situation is different: attitudes and laws about gambling vary from state to state, but largely make it an illegal activity. This situation generates uncertainty and discourages firms from operating transparently.

The Case of Sportingbet.com

Sportingbet claims to be the leading global online sports betting operator. By the end of 2002 it had 558,600 customers and a £991,5m turnover¹². Compared to its 2000 figures (90,065 customers and a £129,9m turnover), the company's growth has been incredibly rapid, but the company still only accounts for 1% of world online gambling market share.

Sportingbet's value proposition is "to provide adults who enjoy gambling with high quality services in an environment that is convenient, entertaining, fair, regulated and secure". Their vision is that "any customer, anywhere in the world, should be able to bet via the company's websites or call-centers without any barrier". In a clear manifestation of this strategic intent, the company has so far put measures in place to allow customers from 150 countries to bet in 23 accepted currencies and to interact with the system in 9 different languages¹³.

¹² Annual Reports 2000, 2001 and 2002, Sportingbet Plc www.sportingbet.com.

¹³ Annual Report 2002, Sportingbet www.sportingbet.com.

Although its share price has been dramatically affected by the bursting of the internet bubble, Sportingbet is one of the few companies that have managed to succeed in the sports wagering industry against traditional bookmakers' online businesses. The key points of Sportingbet's strategy are:

Market Segmentation - Sportingbet limits both individual bet sizes (the average bet size is £50)¹⁴ and the total amount bet on any particular sporting event. The company's target customer is one who gambles for leisure and not to provide an income. Moreover, "professional players" do not presently seem to be attracted by the internet and prefer to use more traditional channels such as call-centers which are much more costly for operators. The strategy is to attract retail customers and not the more risky high stakes clientele. This strategy is followed by many of the other online gambling operators such as betinternet.com that is currently trying to reduce its call-center business.

Moreover, the demographic of a global online customer is a much higher staking customer but staking less frequently than for example the average traditional LBO customer¹⁵.

Increasing Volume - Sportingbet's goal is to increase its revenue per customer, not by having them stake larger amounts, but by increasing the number of bets per consumer driven by the company's wide offer of betting options and sports.

Customization - Sportingbet uses its advanced technology and market knowledge to offer customized services to its customers: in the USA the website reflects the masculine profile of the average style while in Asia it makes full use of colorful animated graphics. Germans seem to be the most risk averse and like to go over the terms and conditions of the games several times. Accordingly, this type of technical information is more accessible on the German website.

Economies of Scale - Organic growth versus acquisitions: Sportingbet's growth is mainly due to local acquisitions. Its strategy is to leverage local expertise to minimize risk and to use the local marketing partner's knowledge of local requirements and media. Sportingbet provides backend systems (software, legal infrastructure, payment processing facilities, etc.) and the partner is responsible for the front-end customer-facing elements.

¹⁴ Annual Report 2002, Sportingbet www.sportingbet.com.

¹⁵ Interview with Nigel Payne, appeared June 2002 in www.Unquoted.co.uk.

Nigel Payne, the CEO of Sportingbet described the business as follows¹⁶: “The beauty of the Sportingbet business model is that for every \$100 of incremental gross margin, which we derive, as we grow, 50% falls straight through to the bottom line. Of the 50% spent, 30% goes on marketing 10% on banking and administration fees and 10% on salary and in frastructure”.

Regulation - Many online gambling firms have based themselves in places such as the Isle of Man, Bermuda, etc to avoid regulation and taxes. Instead, Sportingbet prefers to operate under the British Regulatory framework and to be quoted in the Alternative Investment Market (AIM) of the London Stock Exchange. These two considerations provide the principal intangible assets Sportingbet has and that are the determinants of success for any online gambling company: trust and transparency. Sportin g bet has systems in place to fight credit card fraud and to deter unsuitable gamblers. Money-laundering is also prosecuted.

Even though Sportingbet has grown rapidly and is profitable (see Appendix I), it has not been as successful as the incumbents’ online offerings. We believe this to be because the incumbents have advantages in the competitive drivers as outlined earlier in this paper. This is also one of the contributory reasons why many of the less professional and less well financed companies have been so spectacularly unsuccessful. To a large extent the only innovation of the new entrants was the channel innovation, which was not enough to overcome the incumbents’ advantages in brand and marketing, economies of scale and risk management skills. The few new entrants, such as Sportingbet, who were successful managed this because they were able to establish trust and a strong brand and, through successful marketing campaigns, were able to reach critical mass.

In order for a new entrant to be able to challenge the status quo, a novel betting model would have to be developed.

¹⁶ Interview with Nigel Payne, appeared June 2002 in www.Unquoted.co.uk.

III. THE SECOND CHALLENGE: A NEW MODEL

Betfair entered the online gaming space in June 2000 with a concept known as “exchange betting”, a peer-to-peer model similar to that of eBay. The site matches pools of individuals who want to bet on a certain result (“backing” a team) with pools of individuals who are willing to offer odds on the opposite result (“laying” a team). The user logs onto the site and either accepts the odds of his choosing or specifies the odds he would like, if no one is currently offering them, and waits for another user to accept them. Through Betfair, backers find their layers (and vice versa) anonymously; the user sees only the exchange interface and never knows who he’s betting against.

Despite being a UK-based operation, Betfair attracts users from many different continents. Users of the site can take positions on events ranging from British horse races to American football to the level of rainfall in Wales to the next eviction on the Australian version of Big Brother, regardless of their physical location. There are certain countries which prohibit online or cross-border gambling, and Betfair makes some effort to enforce those rules. For example, cross-border gambling is illegal in the United States, so American credit cards are not accepted as a method of payment.

Betfair earns revenues based on a commission of 2-5% of the gross winnings on a certain event, compared to a figure around 14% for traditional bookmakers. The exact commission depends on how much the user has already won on the site. Losers pay no commissions. Turnover (gross amount of bets placed) in 2002 was around 1.5 billion pounds; current turnover is reported to be on the order of 50 million pounds per week. Future turnover is expected to exceed that of Coral, one of the big three incumbent bookmakers¹⁷.

At the end of 2001, as the market for dotcoms began to shrink, Betfair was financially sound enough to acquire struggling competitor flutter.com. The merger resulted in pooled resources and an even stronger critical mass of users. Betfair achieved profitability as a company in early 2002, less than two years after its initial launch.

The technology of the site was developed by founders Andrew Black, a statistician, software designer, and former professional gambler, and Edward Wray, a former

¹⁷ *Financial Times*, November 26, 2002.

investment banker, and is currently pending patent. Strategic investors in the site include Benchmark Capital, UBS Capital, and JPMorgan Chase.

Marketing

Betfair's value proposition lies in its ability to connect backers with layers and create a safe and credible mechanism for bets to be made. By its nature, the service appeals to a particular segment of the betting market who is comfortable with the internet and perhaps technically savvy (as many professional punters tend to be). The Betfair user is comfortable with betting, is primarily concerned with finding the best odds available and likes the flexibility of being able to back or to lay (an option not previously available). The user base has grown naturally as Betfair has achieved higher and higher awareness.

One consumer segment which incumbents serve better consists of punters who enjoy going to the local William Hill or Ladbrokes branch and placing bets as they watch the races on television. To tap into this market, Betfair has teamed up with Scottish bookmaker Henry Spurway to create easibet.net. The exact details of this agreement have not been publicly disclosed, but the idea is to combine a traditional bookie shop with an internet café so punters to create where punters can bet on exchanges while watching races on televisions in the café. In February 2003, Spurway obtained approval from the Edinburgh licensing board and has plans to 100 stores throughout the UK¹⁸.

Indeed, Betfair appears to be pursuing the link between television and the internet aggressively while remaining a pure internet portal. In another deal with Sports Café, which operates several betting outlets in the UK, Betfair intends to feature its brand prominently in all Sports Cafes and display live odds on television¹⁹. Internet kiosks will be provided for frequenters of the cafes to place bets on the site; the internet will remain Betfair's only channel of distribution. Betfair has also recently announced its sponsorship of interactive television betting channel Attheraces.

On a broader level, Betfair has made some general efforts to invest in its brand equity. As part of its marketing activities, the company has become a sponsor of the Fulham football club and is the fourth biggest sponsor of horse races in the UK.

¹⁸ *Scotland on Sunday*, February 23, 2003.

¹⁹ *M2 Presswire*, April 14, 2003.

Why incumbents should be afraid

The Betfair model neutralizes most of the competitive advantages enjoyed by incumbents:

Reputation & Credibility - The primary advantage that incumbents have over Betfair is the credibility of the franchise name. To combat this, Betfair has made efforts to reassure punters that betting on their exchange is safe and fair. As a matter of policy, all users of the site must create an account with Betfair and deposit money via credit card, cheque, or wire transfer. There must be enough money in the account to fully cover a position before a user is allowed to take that position. Betfair manages the transfer of money between accounts once the result of a bet is determined. The site borrows legitimacy in account management from its partnerships with Databank and the Royal Bank of Scotland. Additionally, the site does not extend credit, so it does not attract punters who like to bet on margin, and in doing so raises the integrity of their operation.

As a result of the vocal stance that incumbents have taken against betting exchanges, Betfair has been featured prominently in the UK press. Journalists portray the bookmakers as old world barons reluctant to lose their empire in the name of freer markets. At the same time, Betfair's brand is legitimized in the eyes of the masses as a successful institution in the new betting exchange arena. Punters are inspired to use Betfair as a statement against the greedy incumbents.

Cost Structure & Scale - Betfair is an internet portal and sustains lower fixed costs than the incumbents. The cost of technological capacity as volume on the website increases is likely to be lower than bricks and mortar costs necessary to acquire the same volume.

Risk Management - Though Betfair is licensed in the UK as a bookmaker, it functions more as an agent who takes no principal risk. All losses are paid out by the counterparty, so Betfair makes money on every outcome. Thus the sophisticated statistical algorithms used by incumbents to set odds are unnecessary. Betfair can achieve profits while leaving users to set the odds themselves.

Does Betfair have sustainable advantage?

Critical Mass

As with other internet exchange concepts, a large part of Betfair's success derives from its ability to attract a critical mass of users to provide liquidity. We can think about critical mass as the number of users necessary to achieve significant cost differentiation from traditional bookmakers. Because the exchange serves a diverse population of punters, many of which have higher tolerance for risk than William Hill or Ladbrokes, and also because it demands a much lower margin, Betfair is able to provide odds up to 20% better than incumbents²⁰.

As with eBay, network externalities make a site with more users more valuable. A layer who wants to offer odds will go to the site where his odds are most likely to be accepted. However, one would imagine that the marginal value of the additional user would decline significantly after some critical mass. The difference between 1,000 and 10,000 users is much greater than between 11,000 and 20,000. In the online auction space, the challenge for new entrants is to acquire and maintain the initial critical mass of bidders. This task appears much more feasible in the betting exchange space.

Betfair differs from eBay in that the only boundaries that limit the location of Betfair users are legal ones. With eBay, markets may be defined by country due to concerns about shipping to foreign countries, shipping duty, cultural barriers, and so on. With Betfair, the product is simply financial gain. After initial concerns about currency conversion are settled, there is no difference between odds made by a user in Chicago or Hong Kong. As such, the potential population from which to create a critical mass is global and vast.

Strategically, this means that although Betfair currently commands the largest base of users as the first mover, it is not as difficult for competitive betting exchanges to enter the space. If another betting exchange could also establish a critical level of liquidity by tapping into international markets, it would in theory be able to offer the same odds on the same range of events as Betfair. For example, if a competitor cannot attract enough users within one market, say one dominated by Betfair like the UK, it can go to another country where Betfair is less dominant, achieve critical mass, and come back to the UK to offer a highly competitive product.

²⁰ According to an independent survey cited by Betfair in numerous press releases.

We might then say that critical mass, as defined above, is not as unique in the betting exchange space. At the moment, there would appear to be room in the market for more than one pool of critical liquidity. Betfair continues to grow dramatically and expand internationally, perhaps in an effort to pre-empt the strategy of new entrants. It remains to be seen whether it will continue to realize new significant advantages in odds provided beyond the requirement of the initial critical mass.

User Loyalty

If online punters are plentiful in supply worldwide (no rarity of inputs) and odds do not improve dramatically with mass beyond a critical point of liquidity (low cost differential), then user loyalty becomes an important issue in sustaining Betfair's advantage. Not only is maintaining a high volume of users necessary for providing better odds, it also serves to slow the ascent of new entrants within the same country.

In theory, the cost for a user switching from one exchange to another is nothing more than opening an account with the new exchange and transferring money from one site to another. To increase switching costs, Betfair has implemented a sliding scale commission charge, which shrinks with the amount of money actually won on the site from 5% progressively down to 2%. Winnings for each user account are tracked on a cumulative basis, and more recent winnings weigh more heavily than older historical ones in determining commission. This scale results in significant financial incentive for a user to do all his business on one site as opposed to spreading it over two or more sites.

Competition

Another betting exchange based in Ireland called Betdaq was launched in September 2001 with the intent of capturing the high-end gambling market and focusing on the Far East where the market is enormous and where traditional bookmakers are not institutionalized. The Betdaq model is nearly identical to that of Betfair, using "proprietary" technology to match backers and layers. The range of events on offer is comparable, and Betdaq charges only 2% commission or less, again depending on how much a user has already won on the site.

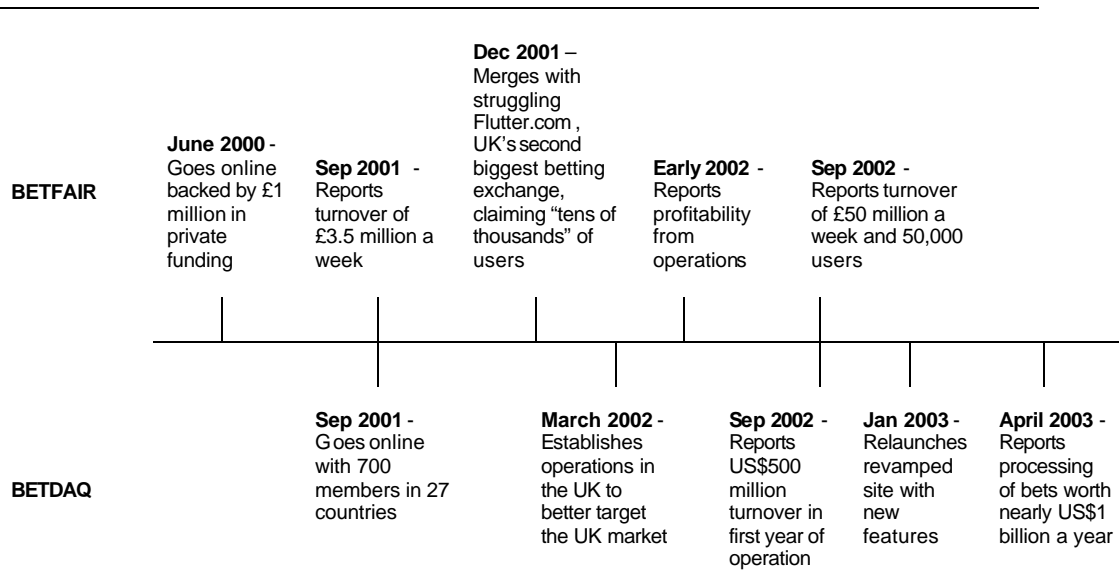


Figure 5. Timeline of key events for Betfair and Betdaq. Source: Various press releases and company websites.

In contrast to Betfair, Betdaq experienced a number of technical problems in the UK where users did not like its user interface. To make matters worse, Betdaq confused punters by launching a separate website betdaqracing.com to compete specifically in horseracing. Initially, Betdaq aimed to capture the "high rollers" market and required minimum bets of US\$100 to accept an offer or US\$500 to make a new offer. But after failing to compete effectively with Betdaq and realizing the importance of liquidity and brand recognition, Betdaq relaunched its UK site in early 2003 with an interface not unlike that of Betfair and changed its minimum bet to 5 euros.

Betdaq has managed to achieve a significant amount of liquidity despite its difficulties and despite receiving far less attention in the press than Betfair. It currently processes approximately 20 million pounds in bets per week (40% of Betfair's turnover)²¹. Betdaq's user base outside of Europe (approximately 60% of its business) allows it to be competitive with Betfair in the UK where it hopes to move in on the horseracing market. Approximately 70% of the bets placed on Betfair revolve around horseracing, while 70% of Netdaq's business involves football, perhaps reflecting the higher popularity of the latter in Asia.

As a part of its focus on the Asian market, Betdaq is also in the process of developing new technologies which allow the betting exchange to be accessed

²¹ *Racing Post*, Feb. 12, 2003.

from mobile phone handsets, so that bets can be placed from the site of the event. This may also increase market size in regions where mobile penetration exceeds internet penetration (for example Japan, which is expected to be one of the largest markets).

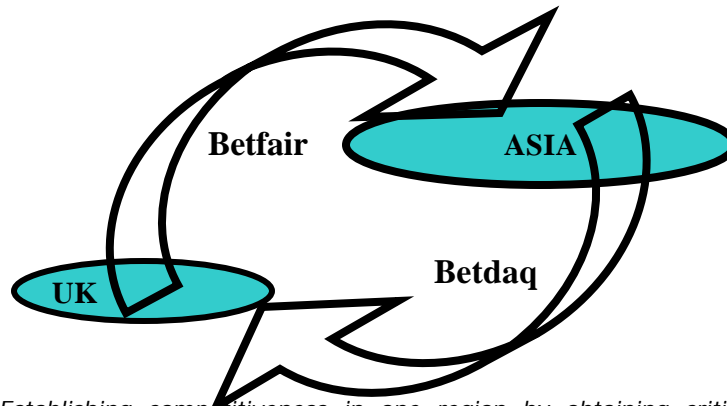


Figure 6. Establishing competitiveness in one region by obtaining critical liquidity in another.

The ease with which Betdaq is growing its user base reinforces the idea that the betting exchange space is wide open to new entrants. The existing sites understand this and are making strong efforts to expand internationally across regulatory restrictions in order to capture more users. While the impact on betting odds of an expanding user base beyond a critical liquidity point is not obvious, the strategic benefits of collecting loyal users are clear. The more punters locked in by a particular web site, the more difficult it is for a new competitor to enter.

What the incumbents are doing

Thus far, the largest incumbents have not made any attempt to enter the betting exchange space. Clearly, they would prefer to preserve the higher margins they enjoy on their existing business by stopping Betfair's momentum. To this end, they have tried to frame the betting exchange concept as something illegal and lacking in integrity. They have claimed that all exchange users who lay a bet should be licensed as a bookmaker. They have pointed out that the exchange leaves room for fixed races should a horse jockey decide to lay against himself. Their efforts to date have been largely taken the form of legal lobbies and appeals to governing bodies such as the Levy Board, which presides over horseracing in the UK.

None of the attempts to bring the exchanges down has been very successful. Betfair and Betdaq are both licensed as bookmakers (despite a different business model) and pay the same 15% tax as the incumbents on their earnings. As the battle continues, Betfair continues to grow at 15% a month and even receives free positive publicity from the press coverage of the issues at hand. It seems only a matter of time before the incumbents realize that the betting exchange concept will continue to manifest itself in some form or another.

Even if the incumbents do accept the innovation, it is unclear whether they are financially capable of transforming their business. The good news is that there is still room for new entrants, particularly ones with large marketing budgets and existing relationships with governing bodies. The bad news is that a betting exchange is less profitable than traditional bookmaking and is likely to become even more so as competition increases and commissions are pushed down. Incumbents would have to make investments in technology and marketing to enter a lower margin business while maintaining their declining core business at the same time.

CONCLUSION

The Internet has created two waves of innovation in the gambling industry. The first wave involved using the Internet as a new channel of distribution for traditional bookmaking services. This allowed new markets to be tapped in areas of the world where opportunities for gambling did not exist before. Small bookmaking startups appeared in an effort to capture share of this rapidly growing market but were unable to significantly challenge the incumbents who also entered the space with their own websites.

The second wave involved a concept innovation known as the betting exchange. This model created a new market where entrants can overcome existing incumbent advantages in scale and risk management. Entrants have experienced rapid growth and compete internationally to capture more users. As the potential online user base is vast, the opportunity for new entrants is ripe. However, incumbents have thus far been unwilling and perhaps unable to enter this lower margin space.

From our analysis, we pull three key learnings:

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1. Channel innovation alone does not overcome incumbent advantages. The Internet offers a way to reach new punters and grow the market. However, startups using this technology have no unique advantage over incumbents, particularly when business in other channels remains profitable and allows incumbents to enter the channel with better funded efforts of their own.
 2. The nature of the boundary-free internet and of the gambling product makes the battle for user base global. The advantage of critical mass is more difficult to sustain when the potential user base is so large. This increases the likelihood of new entrants and increases the importance of effective marketing and creation of switching costs.
 3. Incumbents can be hindered by the desire to maintain higher margins. Though the betting exchange model clearly offers superior value to punters and is quickly stealing business away, incumbents are reluctant to embrace the disruptive innovation because it threatens their dominance and their prolonged ability to generate profit. This attitudinal barrier and the inability of incumbents to rapidly shift business models lead to their slow deterioration.

APPENDIX 1: Financials for Selected Bookmaking Startups

Sportingbet Plc

PROFIT & LOSS ACCOUNT

	31 Mar 2002	31 Mar 2001	31 Mar 2000
Average Shares In Issue (m)	148.05	115.14	103.76
Turnover (m)	991.522	324.671	27.42
Operating Profit (m)	6.473	-3.611	-5.051
Pre Tax Profit (m)	5.042	-4.198	-5.007
Earnings After Tax (m)	5.005	-4.2	-5.007

Sportingbet vs Ukbetting and Betinternet

	Sportingbet	Ukbetting	betinternet
Turnover (m)	991.522	39.083	52.626
Operating Profit (m)	6.473	-6.616	-1.693
Pre Tax Profit (m)	5.042	-8.834	-1.984
Earnings After Tax (m)	5.005	-8.834	-1.984
Market Capitalization (£m)	£40.36 m	£10.12 m	£4.01 m
Operating Margin (%)	0.65	-16.93	-3.22
Profit Margin (%)	0.51	-22.60	-3.77
Return on Equity (ROE) (%)	N/A	N/A	N/A

