

Online Gambling RAISES THE ANTE

Betfair is spicing up the \$8 billion Internet gaming market with its EBay-like strategy and talk of a possible IPO. Regulatory issues and a backlash from traditional gaming houses may sway the odds against it.

By Kambiz Foroohar

◀ On a rainy July afternoon on the opening day of Glorious Goodwood, a two-century-old British horse-racing extravaganza, cricket star Michael Atherton is mingling in the box rented by Betfair, an online gambling site that processes 2 million wagers a day, six times the trades on the London Stock Exchange.

Betfair co-founder Andrew Black, 42, sneaks in two hours late, flinging a blue tie around his neck to conform to the “jacket and tie” dress code. “I’m still feeling rough,” Black quips. Twelve hours earlier, he’d dressed up as a jockey with a cap and leather whip at a late-night party to celebrate the fifth birthday of his company, London-based Sporting Exchange Ltd., which operates under the Betfair name.

Black has more than one reason to celebrate. In June, Betfair hired Morgan Stanley, the world’s largest securities firm, and Goldman Sachs Group Inc., the second-biggest adviser for global acquisitions, to look into its financial options,

including a potential initial public offering. Given the valuations of gambling companies that have gone public in the past six months, Betfair would be worth as much as 600 million pounds (\$1.1 billion), says Martin Oelbermann, a director at Munich-based research firm MECN GmbH. The valuation takes Betfair’s profit of £17.1 million for the year ended in April and applies the price-earnings multiples of online gaming companies such as Empire Online Ltd., which directs gamblers to poker Web sites.

“The Internet has proven to be a fantastic medium for gambling,” says Richard Carter, an equities analyst who covers the leisure industry at London-based brokerage Numis Corp. He says as many as seven Internet gambling companies may sell shares to the public this year. “Every online gambling sector is growing faster than its land-based counterpart,” Carter says, comparing Internet gaming to traditional betting shops and casinos.

For valuations to hold, double-digit growth is needed, analyst Leyland says. 'We are skeptical,' he says.

Online gaming generated \$8.2 billion in revenue last year, or about 3 percent of the \$243 billion global gambling market, according to New York-based research firm Christiansen Capital Advisors. The online poker market alone soared to \$1 billion in 2004 from \$92 million in 2002. While revenue at traditional casino and gaming companies is likely to edge up 3 percent a year through 2009, revenue at online companies will surge about 22 percent annually to reach about \$23 billion in that year, Christiansen predicts.

Oelbermann says Betfair stands out from competitors. He compares it to EBay Inc., the San Jose, California-based online auction house that matches buyers and sellers in a global marketplace. Betfair charges nothing to a person who offers a wager. It takes a maximum cut of 5 percent of a winning bet. The strategy eliminates the bookmaker, the agent who offers odds and accepts bets for a fee. In traditional casinos or gambling sites, customers play against the house, which builds a profit margin into the odds, making it hard to win, Black says.

In contrast, Betfair is a betting exchange—an inspiration Black says he took from his stint in 1995 trading U.S. equities and learning about the New York Stock Exchange. A person who accesses Betfair's Web site can offer a bet and set the odds. If the odds are attractive, other bettors will take the counter position. This happens with split-second timing, and it's anonymous. Everybody has funds in the system to back their wagers. Transactions are reconciled immediately after the event is completed.

Betfair's 300,000 clients can—and do—bet on anything, from whether New York Senator Hillary Clinton will win the 2008 Democratic Party presidential nomination to how high home prices will rise in the U.K. to who will win MTV's best dance video. Recent bets slightly favored Clinton's nomination, had housing prices reaching an average of £157,000–£158,999 by December 2005 and had Jennifer Lopez winning in the Best Dance Video category. In May, Betfair notched a company record of more than £10 million of wagers on one event when the U.K.'s Liverpool soccer club came back from a 0–3 deficit against Italy's A.C. Milan to win the European Champions League final on penalty kicks.

"You can't beat the first-mover advantage," says Oelbermann, referring to the benefit he says Betfair and EBay have gained by being the first to strike it big from profits on client transactions. "Nobody will be able to beat Betfair unless the management makes a massive mistake."

Any online gambling IPO would be

shooting for a debut like that of PartyGaming Plc, which runs PartyPoker.com, the world's biggest poker site. The Gibraltar-based company went public in June, raising £1.04 billion. It was the U.K.'s biggest IPO since Reading, England-based Yell Group Plc, which publishes Yellow Pages directories, raised £1.2 billion in 2003. Since its debut, PartyGaming's stock has risen 38 percent from its IPO price of 116 pence to 160 pence on Aug. 9, boosting the company's market value to £6.55 billion—twice as much as that of British Airways Plc, Europe's No. 3 airline.

The gambling craze has helped other online sites. The share price of Sportingbet Plc, which operates an online casino, accepts sports wagers and runs poker games, has increased 92 percent this year to 364 pence on Aug. 9, giving the London-based company a market value of £1.2 billion. Empire Online, based in the British Virgin Islands, raised £123.5 million on June 15 on the Alternative Investment Market, the London Stock Exchange's bourse for small companies. By Aug. 9, the shares had climbed 40 percent to 243.5 pence.

"The next wave of activity will be mergers and acquisitions," predicts Nigel Payne, Sportingbet's chief executive officer. "There will be 50 M&A deals in the next two years."

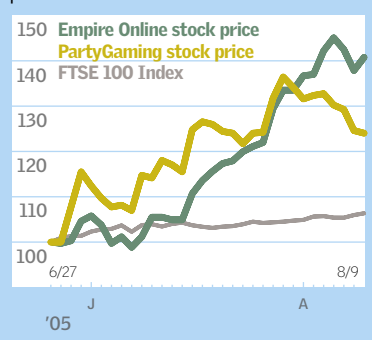
Getting big quickly may be the best way to ensure survival. Sporting Options Plc, a betting exchange like Betfair, filed for bankruptcy protection with debts of £5.4 million in November 2004. Started in May 2002, Sporting Options took a maximum cut of 3 percent on a winning bet, less than Betfair's 5 percent ceiling. By 2003, losses had widened ninefold to £1 million. The company struggled to attract 5,500 customers, less than 1/10 of Betfair's regular monthly clients.

Black, who provided a £3.5 million bailout for Sporting Options customers and took on some of the company's bets, declined to comment on plans for a Betfair IPO. He prefers to talk about how his company lets him do what he knows best. "I read somewhere that to be a successful entrepreneur means being able to do things that you don't like," Black says as he watches half a dozen horses speed by Betfair's box. "That's not me. I don't like to do things that I don't like."

From his earliest years, conforming was never part of

Black's agenda. His grandfather was Sir Cyril Black, a teetotaler who campaigned against gambling as a Conservative Party Member of Parliament for Wimbledon, south of London. The younger Black was expelled from Exeter University in southwestern England after he spent time gambling rather than studying. He stacked shelves at a do-it-yourself store and toured Europe as a golf caddy—a circuitous route to becoming a gambling mogul who's shaking up the old guard. Last year, Betfair processed \$10 billion of wagers. Its strategy of taking a cut of every winning bet

High rollers Shares of these two online betting companies have outperformed the U.K. stock market.



Index: June 27, 2005=100 Source: Bloomberg

translated to a 63 percent jump in profit in the recent fiscal year. Revenue soared 61 percent to £107 million.

The hubbub surrounding Betfair and the host of new gambling sites recalls the Internet bubble of the late 1990s, says Paul Leyland, an analyst at London-based brokerage Seymour Pierce Ltd. "For these valuations to hold, there is an assumption that all companies in the medium to long term can grow at double-digit rates," Leyland says. "We are skeptical."

That's especially true because of regulations in the U.S., a hotbed for online gamblers that produced 87 percent of PartyGaming's \$600 million in revenue last year. In April 2003, Deputy Assistant Attorney General John Malcolm told the Crime, Terrorism and Homeland Security Committee of the U.S. House of Representatives that if online gambling companies accept bets from customers in the U.S., they are violating federal laws. "While the United States can indict these companies or the individuals operating these companies, it may be difficult to bring them to trial in the United States," Malcolm said.

In his testimony, Malcolm referred to the 1961 Federal Interstate Wire Act. The act states that it's illegal to use a "wire communication facility," referring to a telephone, to transmit bets across state borders. Congress developed the act to stop organized crime involvement in sports gambling, says Lawrence Walters, a lawyer at Weston, Garrou, DeWitt & Walters in Altamonte Springs, Florida, who has advised the online gaming industry. "The government has used the Wire Act as a threat against anyone providing services such as payment processing or advertising to the online gaming companies," Walters says. "Even if they are empty threats, public companies are not going to take a chance."

In June 2002, New York-based Citigroup Inc., the biggest issuer of credit cards at that time, reached an accord with state Attorney General Eliot Spitzer, agreeing not to process transactions made at online casinos and other Internet gambling operations. Banks followed suit. MBNA Corp., the Wilmington, Delaware-based bank that Bank of America Corp. has agreed to buy; Chase Manhattan, now part of JPMorgan Chase & Co., the third-largest U.S. bank; and Wells Fargo & Co., the top U.S. home equity lender, have agreed not to process online casino transactions. American Express Co., the fourth-biggest U.S. credit card issuer, prohibits cardholders from using their cards to gamble on line worldwide.

In July 2002, Spitzer subpoenaed PayPal Inc., the payment provider owned by eBay, questioning its use for online wagers. PayPal agreed to end payments for online gambling.

U.S. Justice Department spokesman Bryan Sierra declined to comment on specific online gambling companies or cases. "Our view is that online gambling in the United States is illegal," he says.

PartyGaming CEO Richard Segal says his company isn't doing anything wrong. "We are satisfied that what we are doing is not illegal," he says. Segal says he bases his reasoning on a court case in Louisiana and a ruling by the World Trade

Organization. In 2001, Judge Stanwood Duval of the U.S. District Court for the Eastern District of Louisiana in New Orleans dismissed a case against the world's second-biggest credit card brand, MasterCard International Inc. The suit asserted that MasterCard had run afoul of the Wire Act when it let customers use their cards to gamble and lose money at online casinos. The claimants argued that they shouldn't have to repay their debts because online gambling is illegal.

"At this point in time, Internet casino gambling is not a violation of federal law," Duval ruled. The Fifth Circuit Court of Appeals, also in New Orleans, affirmed the decision in November 2002. Then in April 2005, the Geneva-based World Trade Organization's appellate body said that because a number of U.S. states allow online gaming on lotteries and some permit online betting on horse racing, it was difficult for the U.S. to justify banning online gaming internationally.

Black says Betfair avoids these legal headaches by taking no bets from U.S. residents. Customers must give their address to register and submit bank details to deposit money into their account before they can wager. "We don't accept bets from customers with a U.S. address or U.S. credit card," says CEO Stephen Hill, 44, sitting in a corner room in the company's glass and steel offices overlooking the Thames in West London.

On its home turf, Betfair is irritating traditional betting houses. David Harding, CEO of William Hill Plc, the U.K.'s biggest gambling company, says Betfair fosters unlicensed bookmaking because it lets anybody act as a bookmaker. The U.K. requires that bookmakers hold a permit from the Betting and Licensing Committee of a local Magistrates' Court. "If I go into a pub and offer to take bets from the public, I'd be arrested," Harding says, adding sarcastically, "I do it on my computer, then that's perfectly fine."

In addition, Harding says, some regulated bookmakers use Betfair to avoid paying the U.K. racing levy. U.K. law mandates that bookmakers pay as much as 10 percent of their gross profits to the horse-racing industry. When a licensed bookmaker offers a bet on Betfair, he avoids paying that tax, Harding says. "No overheads and no taxes to pay means that bookmakers using Betfair can offer better odds," he says. Betfair itself is subject to the U.K.'s 30 percent corporate tax and 15 percent gross-profits tax on its take of customers' winnings.

The rise of online casinos is also prompting debate about gambling addiction. People who gamble on the Internet may be more likely than traditional gamblers to have a problem, says Guy Clark, chairman of the nonprofit, Washington-based National Coalition Against Legalized Gambling. Clark cites a report by University of Connecticut psychologists George Ladd and Nancy Petry, who studied the gambling

'At this point in time, Internet casino gambling is not a violation of federal law,' a U.S. judge ruled.

behavior of 389 people. They found that almost 11 percent were problem gamblers and more than 15 percent met the criteria for pathological gamblers, showing an inability to resist the impulse to gamble. The study further identified those with Internet gambling experience as having the most serious addictions. "There is an awful lot of opposition to foreign online gambling companies becoming pervasive across the U.S.," Clark says.

Black grew up around traditional betting shops, the smoke-filled parlors where anyone can wager on a sporting event—mostly horse races or football matches. The son of a property developer, Black attended Kings College, a private school for 7- to 18-year-olds in Wimbledon, the same district that his grandfather represented in Parliament. He got the nickname "Bert" when a teacher mistakenly called him by the wrong name.

Even as Black's grandfather legislated against drinking and gambling, Black's father took his 8-year-old son to the Goodwood racetrack in the Sussex countryside. Black says he became hooked on the excitement and the tactics for picking winners—an avocation that hurt his studies when he enrolled at Exeter to study mathematics in 1981. The university expelled him two years later for failing some of his exams, he says. "I got good grades in the ones I did take," Black says, declining to say which ones those were.

Black followed with part-time jobs. In between, he tried to perfect his gambling to make a living betting on horses and playing bridge. In 1984, Black met his best friend, Jeremy Wray, at the Young Chelsea Bridge Club in London's Earls Court neighborhood.

In 1986, Black's brother Kevin, who was five years younger, contracted a brain infection that left him a paraplegic. Kevin died in 1988. Black says he decided to seek a regular job, joining the London branch of Track Data Corp., a New York-based financial information services company.

All the same, he kept up his visits to the bookies. In 1992, he made his first big gambling profit. Black walked into his local bookmaking shop in Broadgate, near the Liverpool Street train station. He put down a £20 combination bet on two horses named Party Politics and High Low to win the so-called spring double in the Grand National and Lincoln Handicap races. Both horses won, and Black scooped up £25,000. "That was a very good day," Black says with a smile. "That allowed me to quit my job."

He tried his hand at professional gambling and got bored. In 1995, he joined Boxall Asset Management Ltd., a private money management company in London. The firm, which has since disbanded, traded U.S. equities and derivatives. Black traded U.S. stocks, learning how a financial exchange operates. He quit after he had a falling out with his boss, he says, and got married and set himself up writing computer database programs for Internet companies such as Deckchair.com, an online travel agency. "I could come up with creative solutions, which was more valuable than my coding skills," Black says.

The idea for Betfair popped up in 1998 when Black was writing software for the British government's GCHQ, part of its intelligence service. After work, he'd think about how to translate what he'd learned about stock trading to sports betting. "On the NYSE, everyone bids and offers against everyone else," Black says. "You put your bid on the board, and anyone can come and post their bid. But bookies set the price, and you can either take it or leave it."

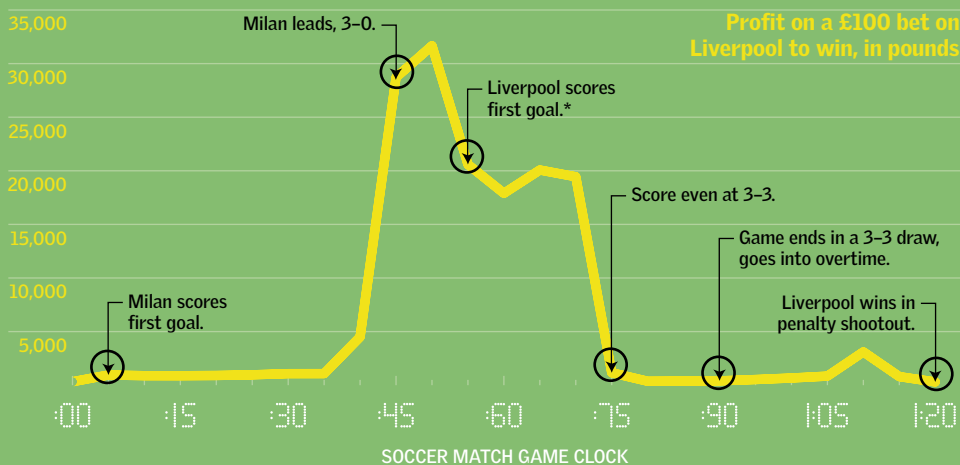
Black began toying with the idea of a site that would allow bettors to bypass bookies and to bet not only on an outcome but also against an outcome, much like shorting a stock. The project foundered until the death of his father in 1999. While his brother's death spurred Black to get a full-time job, his father's death jolted him to pursue his betting-site idea. "So many people go through life with great

ideas and never do anything about it," Black says. "I had to take a chance."

Black put up £50,000 of his own money and persuaded Jeremy Wray's younger brother to join him. Edward Wray, now 37, was a trader in debt capital markets at J.P. Morgan & Co. in London and could provide management know-how and open doors to raise new capital, Black recalls thinking.

With a business plan in hand, the pair visited venture capitalists in London. At the peak of the dot-com boom, they found no takers. One reason was that a

Pay by play On Betfair, gamblers can bet while a game is in progress. Here is how the profits on a £100 bet on Liverpool changed during the European Champions League final on May 25, in which Liverpool recovered from behind three goals to defeat Italy's A.C. Milan.



*In 54th minute. Source: betfair.com

company called Flutter was peddling a similar idea. Josh Hannah, 34, and Vince Monical, 35, former Bain & Co. management consultants from San Francisco, had beaten Black and Wray by getting to the venture capitalist community first. "We tried to raise money and failed miserably," Wray says. "Flutter had been there ahead of us."

Like Betfair, Flutter's site removed the bookmaker from the gambling equation. Unlike Betfair, Flutter was aiming for the casual bettor. "It was about creating a community and a way of settling disputes you make with a friend in a pub or at work," says Hannah, who now runs a San Francisco online information service called Ehow.com and is the entrepreneur-in-residence at Menlo Park, California-based Benchmark Capital, which funded eBay.

Venture capitalists loved Flutter. Hannah raised £30 million from Benchmark, Geneva-based Index Ventures and Zurich-based UBS Capital. Black's idea of an exchange focusing on gamblers found no takers. "Maybe they looked at me and thought I was past my sell-by date," he says. "If you think Flutter is likely to be the leader, then you back it."

Wray and Black turned to friends and family and scraped together £1 million in increments as small as £25,000. Flutter went on line in May 2000. Betfair followed four weeks later. The timing was propitious. Betfair's first day was Oaks Day, a major horse-racing event in the U.K. The company hired an actor to parade in a coffin around Russell Square in central London with a banner that read "death of the traditional bookmaker."

Betfair took in almost £1,000 in bets on the horse race. Black says he knew he had a hit. "Flutter was designed by management consultants who knew the Internet," he says. "I knew gambling. I had been thinking about this for years."

In a few months, Betfair had about 95 percent of the betting exchange market based on volume of bets, says Simon Holliday, a partner at Global Betting & Gaming Consultants, a research firm in Wolverhampton, England. Flutter's Hannah says he realized he'd been outflanked. "This market is about liquidity and size," he says. "It made sense to combine the two companies."

Hannah recalls that the decision to merge Betfair and Flutter happened over beers. The two combined in December 2001. The new company took the Betfair name, and Edward Wray became CEO. Fifteen months later, in April 2003, Betfair was handling £50 million of bets a week and had increased its employees to 200 from 20. The company won a Queen's Award for Enterprise for "outstanding innovation in the sports betting market."

Betfair's arrival is spawning a new breed of professional gamblers. Jonathan Gale, 36, quit his job in the City of Lon-

don, where he worked writing programs to determine options pricing at Deutsche Bank AG and other banks. He now spends as much as eight hours a day in an office 100 yards from his north London house, betting on intraday price movements of stock indexes using four computers and sophisticated software for program trading. "With Betfair, your transactional costs are nil because you only pay a commission on your winnings," says Gale, who says he doesn't regret leaving his job. "In the past 18 months, I haven't had a losing week."

Black is taking his company on the road. In Australia, Betfair has joined with Kerry Packer, the country's richest man, who owns Melbourne's Crown Casino. In July 2004, Black and Packer applied for a license to operate a betting exchange.

The local companies aren't in a hurry to put out the welcome mat. Michael Piggott, CEO of wagering at Melbourne-based Tabcorp Holdings Ltd., Australia's biggest gaming company, says Tabcorp has always opposed betting exchanges. "Licensed bookmakers are the only people that can accept bets," Piggott said via e-mail. "That has been a cornerstone of maintaining integrity in the conduct of racing. The public cannot offer to accept bets."

In the U.K., Betfair has joined forces with Yahoo! Inc., operator of the world's most-visited Web site. Yahoo Betting provides a stripped-down version of Betfair aimed at casual gamblers. It offers a limited number of categories and no wagers on financial indexes or exchanges.

William Hill's Harding wants the U.K. government to tax Betfair on the volume of transactions that cross its exchange rather than on its profits. In March 2004, U.K. Chancellor of the Exchequer Gordon Brown said the Treasury would review the tax treatment of betting exchanges and their clients. A decision is expected in November, as part of the Treasury's pre-budget report, Betfair's Hill says.

Should the report be unfavorable to Betfair, Hill says, the company will give up its U.K. headquarters. "If we have to pay more taxes, we'll move offshore," he says. Betfair already has a license to operate in Malta, which charges gambling companies a 0.5 percent tax on their revenue. "We'd like to be in the U.K. because it offers many advantages," he says, noting that the country's regulatory environment for financial companies would help investors feel safe investing in Betfair.

Regulation, taxes and concerns about gambling addiction all loom as Betfair and other online gaming sites strive to keep their growth streaks alive. The longest odds may be on Betfair's ability to prove that online gambling isn't another Internet bubble ready to burst. ▶

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