Irish bookmakers: a tax increase too far?

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So much for the age-old adage that the bookie always wins. The decision by the Irish government to double the rate of betting turnover tax in Ireland almost certainly means that there will be far fewer bookies "winning" in the years to come. Indeed, those still around will probably be looking up dictionaries to clarify the meaning of the word; they are certainly unlikely to feel like winners.

Paddy Power's Irish shops now face an effective tax rate of 74%; cost will be far higher for others

The increased betting turnover tax introduced in last Tuesday's Budget looks extremely harsh for Irish bookmakers. For the purpose of explaining what I mean, I will use my 2009 Paddy Power Irish retail estimates to demonstrate just how punitive the tax system will now be for Irish bookmakers.

Based on our current forecasts, Paddy Power will generate turnover in its Irish shops of just over €1bn in 2009 (€1,027.2m to be precise). Of this €1bn, an average of 88% will be paid back to punters through winning bets – Paddy Power keeps the other 12%. This means that Paddy Power's winnings (or gross win) will amount to €123.3m. From this figure, the group must pay all of its operating costs (staff costs, marketing, data feeds etc.) which we estimate will be €90m. This leaves the group with profit before tax of €33.3m.

Now let's examine the group's 2009 Irish retail tax bill. As a result of the increase in turnover tax from 1% to 2%, Paddy Power's total turnover tax bill will be €20.5m (2% of the €1.023bn). In addition, it also has to pay 12.5% corporation tax like all other businesses. So that should be 12.5% on the remaining €12.8m profit. Correct? WRONG. Instead, the Revenue Commissioners charge it 12.5% on the full €33.3m (i.e. the turnover tax already paid is not tax deductible), meaning that the group will pay corporate tax of €4.2m. This brings its total Irish retail tax bill to €24.7m – an effective tax rate of 74.2%. That equates to an increase of 30.6 percentage points ... and you thought the Budget was tough on you!

Table 1: Paddy Power’s pre-Budget and post-Budget Irish retail forecasts (€m)

	Pre-Budget Irish retail forecasts (€m)	Post-Budget Irish retail forecasts (€m)
Turnover	1,027.2	1,027.2
Less customer winnings	903.9	903.9
Gross win	123.3	123.3
Operating expenses	90.0	90.0
Profit before tax	33..3	33..3
Turnover tax	**10.3**	**20.5**
Corporation tax	**4.2**	**4.2**
Total tax	14.5	24.7
Effective tax rate	**43.6%**	**74.2%**

Source: Davy

On a per shop basis, this equates to a 54.3% drop in profits. While that is a very significant hit for Paddy Power, there is some small comfort for the company in the fact that Irish retail, prior to the Budget, was expected to account for only 31.3% of its total EBIT in 2009 (now it is even less at just 20.2%). In addition, the fact that the group has a cash pile earning interest also helped; group earnings will "only" fall by 14.6% as a result of the tax change.

Table 2: Paddy Power's profit pre-Budget and post-Budget

	Pre-Budget	Post-Budget
Irish retail net profit	€18.8m	€8.6m
Number of shops	197	197
Net profit per shop	€95,431	€43,654
% change		-54.3%

Source: Davy

Implications for the wider industry

However, the real burden of this tax increase will be felt not on the big multi-channel operators such as Paddy Power; rather, it will be felt most by the estimated 450 small independents throughout the country. For these operators, Irish retail is effectively 100% of their businesses. These shops are at a significant disadvantage for numerous reasons:

- They cannot spread central costs over a wide number of shops, and therefore their profit per shop is considerably lower to begin with.
- They do not have the same quality risk management systems as the market leaders and therefore generally operate on lower gross win margins. That means that the 12% that Paddy Power wins from its customers could be less than 10% in the case of some smaller operators.
- It means that their scope to handle a run of unfavourable sports results (which drives gross win margins down) is dramatically reduced. An unfavourable run of sports results now could potentially put many operators out of business.

Effective tax rate for smaller, less profitable operators is likely to be even higher than for Paddy Power

Take a shop earning half the turnover of a Paddy Power shop – say €2.6m per year and operating on an EBIT margin of just 2.5% (a number that has been repeatedly mentioned to me by industry sources). This implies EBIT of €65,000 per shop. The total tax burden for that shop will be €60,125 as a result of this Budget, implying an effective tax rate of 92.5%! Essentially, the less profitable shops will now face a higher effective tax rate.

The tax system for the industry is therefore badly in need of review. However, any such review is likely to come too late to save many independent operators; expect the number of shops in Ireland to start to fall in H1 2009 from its current peak of 1,250. Failing an immediate review of the system, the inevitable consequence will be that the big three (Paddy Power, Ladbrokes and Boylesports) will increase market share as the smaller operators increasingly go to the wall.

Consolidation is badly needed in the sector and there is excess capacity. But businesses should thrive or fail based on the quality of their management and not on the failings of an inequitable tax system.