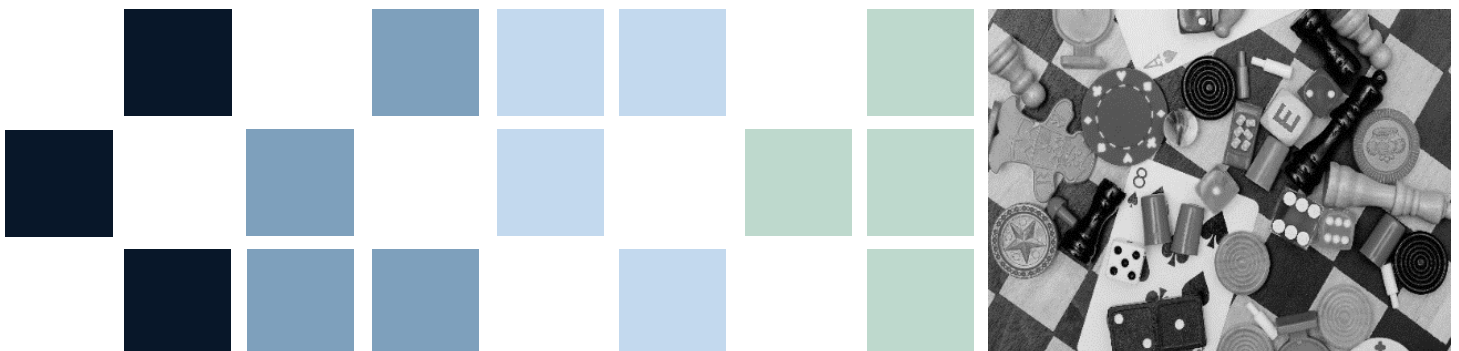


Advice on the implications of the new interpretation of the non-casino gaming machine net proceeds regulation

Effects of a change in financing rule for gambling equipment – report prepared for One Foundation Limited

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11 December 2024

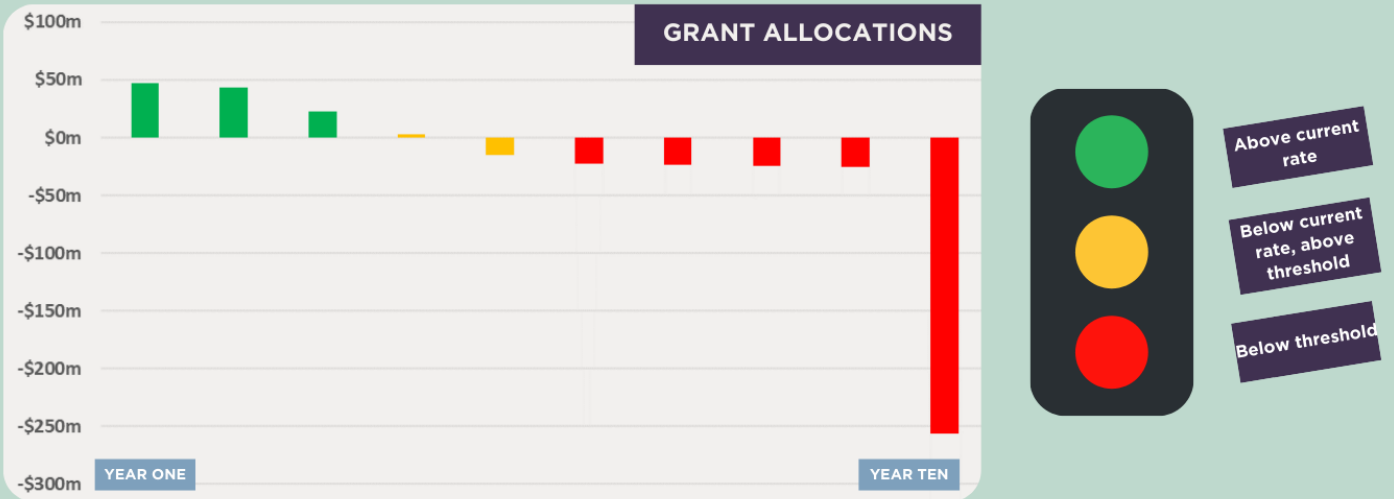


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IMPLICATIONS OF NEW REGULATIONS ON GRANT ALLOCATIONS

Under our forecasts, annual grants will decline by about \$23m per annum within five years of the new rules interpretation.



Note: grants would initially increase given that funds currently set aside for asset purchases would become available for grants. However, over time, interest costs and debt repayments would reduce the grant allocations compared to what they are now. At the end of the 10 year period, the outstanding debt would reduce future grants by \$256m. Our modelling assumes the sector moves from the current model where approximately 8% of assets are funded by debt, to a model where 100% of assets are funded by debt.

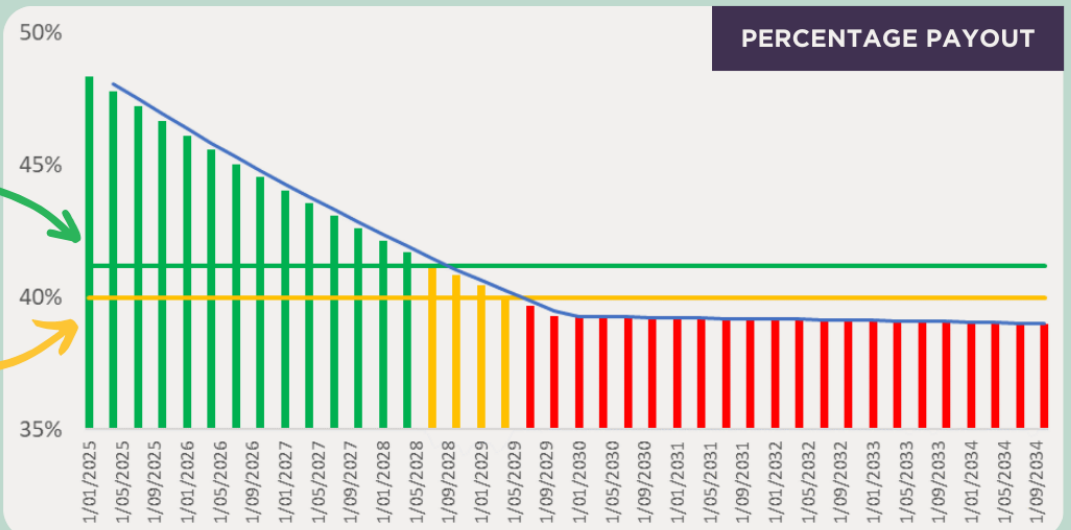
Gaming societies will sustain extra costs of **\$232m over 10 years**, which will ultimately reduce payments to grant awardees

- \$215m** in interest payments
- \$10.7m** in loan application fees
- \$6.5m** in legal costs

The costs in **year 10** are **\$31.6m**, comprised of:

- \$29.8m** in interest payments
- \$1.2m** in loan application fees
- \$0.6m** in legal fees

The grants payout will fall two percentage points, from 41.2% now, to 39% over six years.



Note: The grants percentage would initially increase (as indicated above) but would decline below the current level of grants by 2028, before settling at 39%.

1. Regulation of Class 4 gambling

Class 4 gambling is regulated by the following legislation:

1.1 The Gambling Act 2003

The Gambling Act 2003 (the Act) is the primary legislation governing Class 4 gambling in New Zealand, which includes non-casino gaming machines (pokies) operated by societies. Class 4 gambling is heavily regulated to ensure that proceeds from gaming activities are maximised and distributed to authorised charitable and community purposes. Under the Act, operators must have a Class 4 operator's licence administered by the Department of Internal Affairs (DIA) and adhere to strict guidelines regarding the use of funds and the management of assets.

The strict regulation of Class 4 gambling aims to maximise grants distributed to the community. Section 53 of the Act sets out the grounds for granting Class 4 operator licences, and states that operators must ensure that distributions from gross proceeds are applied only to authorised purposes, primarily benefiting the community.

1.2 The Gambling (Class 4 Net Proceeds) Regulations 2004

The Gambling (Class 4 Net Proceeds) Regulations 2004 complements the Act by providing further details on managing net proceeds.

Under Regulation 10, Class 4 operators are required to distribute a minimum of 40 per cent of their gross proceeds to authorised purposes, typically through grants to community organisations. Gross proceeds is defined as:

- total turnover from gaming machines (less prizes paid out to players),
- plus any interest or other investment returns,
- plus any gains from selling or disposing of gambling assets.

Net proceeds is defined as gross proceeds less the sum of:

- the actual, reasonable and necessary costs of conducting gambling,
- the actual, reasonable and necessary costs of complying with the regulatory regime,
- the amount by which any gambling asset is depreciated,
- any losses from the sale or disposal of gambling assets.

Regulation 11 sets out the timing requirements for the application or distribution of proceeds. Gambling societies must distribute all or nearly all of their net proceeds every quarter within the financial year, and any remainder within three months following the financial year.

1.3 Summary of rule change

The Department of Internal Affairs (DIA) is to change its interpretation of rules concerning gaming machines acquisition for gaming trusts. The new interpretation will force gaming trusts to use debt to

acquire assets instead of using retained earnings. Gaming trusts would then pay down the principal on within the terms of the debt arrangement, which is likely to be a table mortgage approach.

2. Modelling total community grants in retained earnings and debt funding models

In this section, we set out the assumptions, methodology and results for modelling the present value of community grants under essentially a retained earnings funding model (status quo) and 100 per cent borrowings model (alternative).

2.1 Assumptions

Table 1 sets out the assumptions used in our modelling.

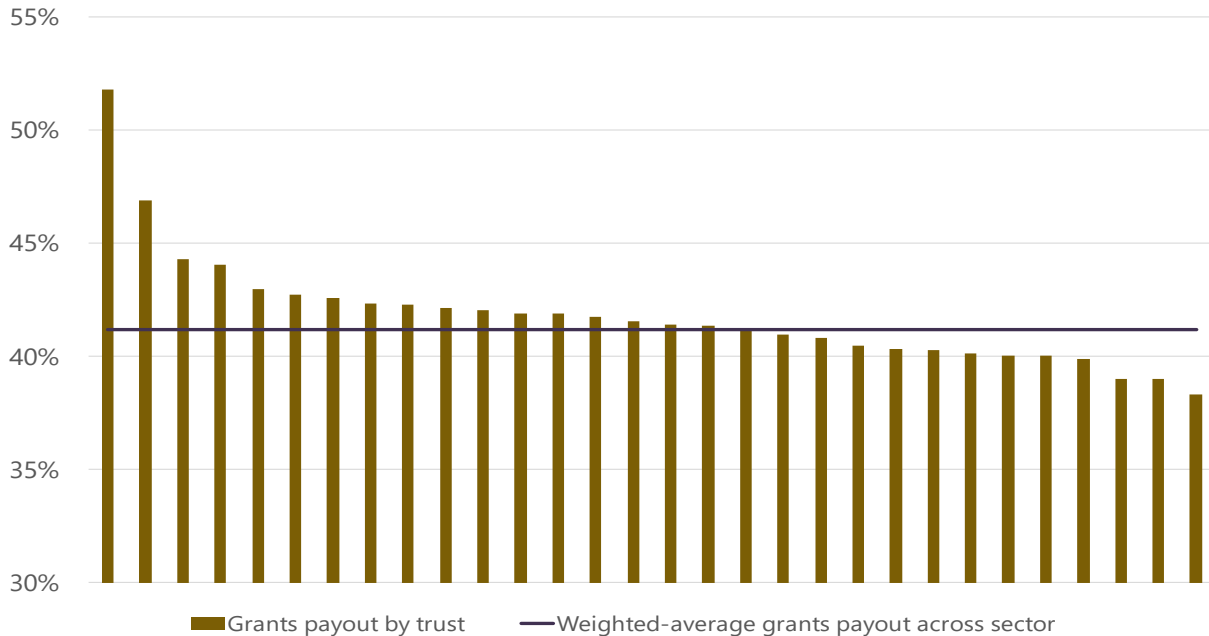
Table 1: Modelling assumptions

Assumption	Value	Source	Comment
Average life of gaming machines	5 years	Based on depreciation rate from Inland Revenue Department (2024)	We use five years as an average, however there will be some variation across gaming trusts.
Depreciation method	21% straight line	Inland Revenue Department, 2024	Using diminishing value is not material on the results.
Interest rate on debt	10.77%	Financial results of trusts (more recent year reported)	The range varies from 7.13% to 13.25%. We note, however, that the average rate may rise if the gaming industry starts to become a large single risk for lenders.
Application fee	1.25% of loan value	Based on advice	This amount must be expensed.
Legal costs	\$6,000 per loan application	Based on advice	Applies to each new loan application, assuming half of all trusts make one loan application per year.
Period of analysis	10 years	Modelling assumption	Allows for full effect of interpretation change to flow through.
Annual inflation rate	2%	The Treasury, 2024	No comment.

Assumption	Value	Source	Comment
Average grants as % of gross proceeds	41.2%	Financial results of trusts (more recent year reported)	See Figure 1 and Appendix A.
Average cost of new machine	\$30,000	Based on advice	Our modelling from financial statements indicated a cost of around \$26,000, however advice is that \$30,000 is closer to the mark. Note that this cost is made up of a number of elements.
Effective date of changes	1 January 2025	Assumed for modelling purposes, not material	Instructed by client
Number of machines	Constant at 14,109 machines	Modelling assumption	We assume that the industry is in a steady state.
GMP/machine	\$74,000	(Department of Internal Affairs, 2024)	We assume that this value will increase at the rate of inflation.
Current debt financing	8% of financing	Financial statements of trusts	We have looked at the total interest expenses of trusts and compared them to what would be required for 100% funding.

Figure 1 shows the current grants payout by trust and the weighted-average payout across the sector using the most recently published annual reports (see Appendix A for a detailed breakdown by Trust).

Figure 1: Grants payout (percentage of gross proceeds) in most recent annual reports across sector



Source: Sapere analysis, Appendix A

2.2 Methodology

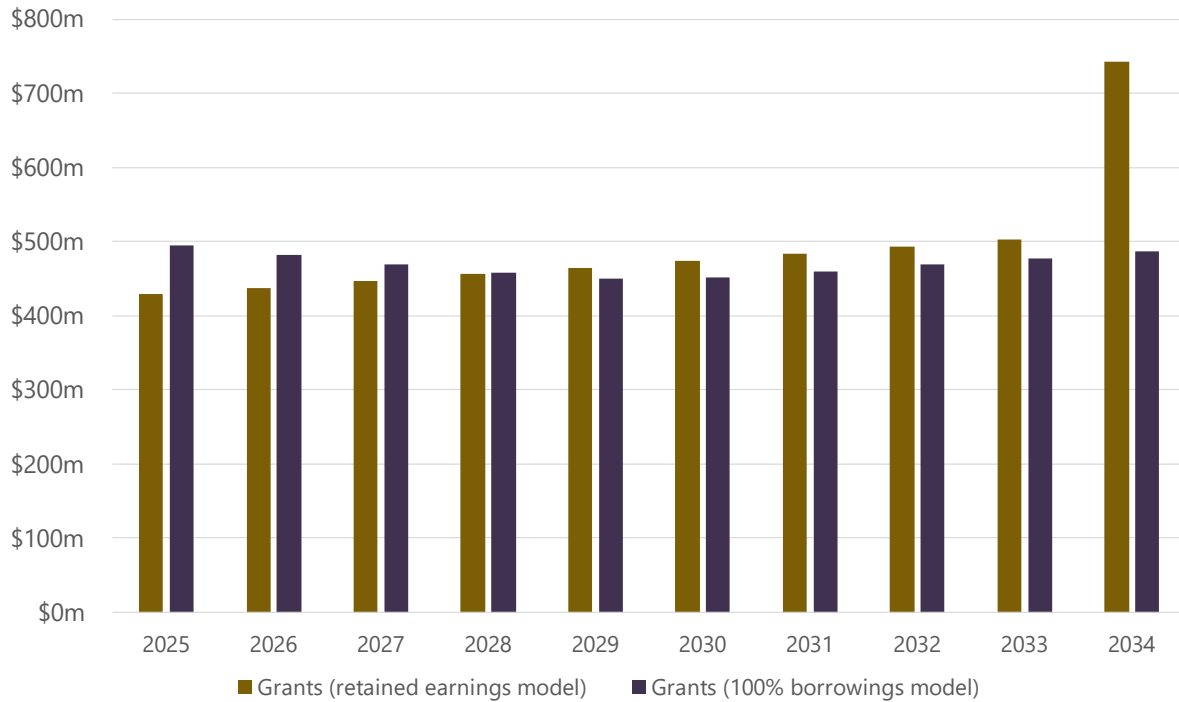
We compare the real and nominal value of grants over ten years in both funding models, summarised in six steps below:

1. Forecast gross gaming proceeds across the sector using current values and inflation.
2. Estimate purchase of assets using the average cost of a new machine, the average useful life and current number of electronic gaming machines (EGMs).
3. Estimate current grant payouts by downloading accounts of 30 trusts and comparing payout to gross proceeds.
4. Retained earnings model (status quo):
 - i) assume gaming machines can be purchased using retained earnings
 - ii) at the end of period of analysis, assume that all assets can be sold at book value.
5. 100 per cent borrowings model (alternative):
 - i) assume PPE must be financed with 100 per cent debt
 - ii) repay principal on lending by repayment equal to depreciation
 - iii) calculate additional interest costs, loan application fees and legal costs
 - iv) at the end of the period, assume that debt can be repaid by the sector.
6. Compare the present value of grants in both models in nominal and real terms.

2.3 Results

Figure 2 shows the estimated annual grants in both funding models over 10 years.

Figure 2: Estimated annual grants in retained earnings and 100% borrowings funding models



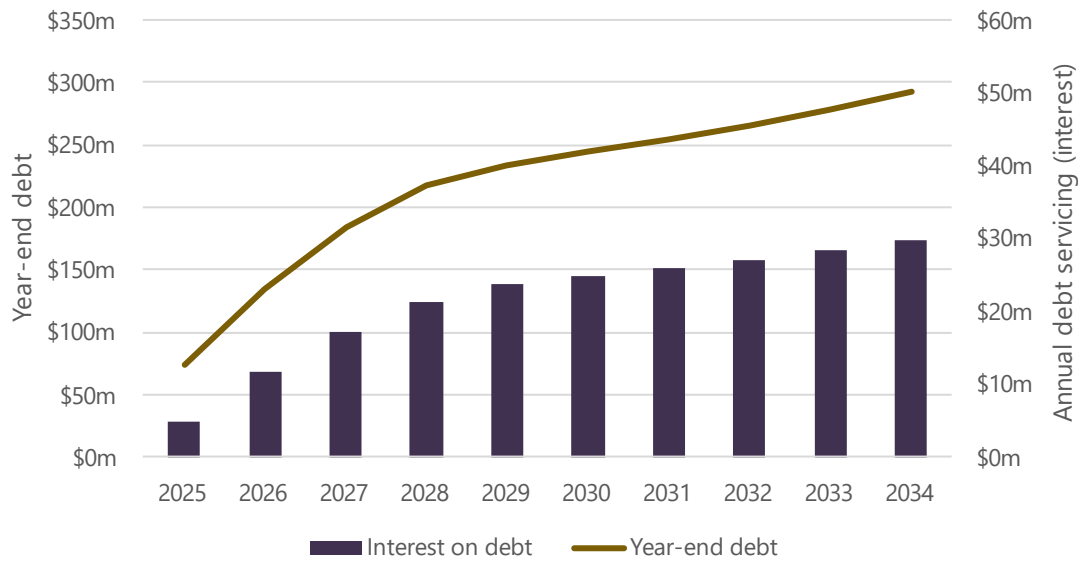
Source: Sapere analysis

Under the 100 per cent borrowings model, grants are initially higher due to the payout of retained earnings. However, over time, grants decrease and ultimately stabilise below the retained earnings model as borrowings costs grow across the sector.

Based on the financial returns of gaming societies (representing 74 per cent) of all the gaming machines currently in use, we estimate that around 8 per cent of fixed assets are currently financed through debt. Our modelling shows what happens when the industry moves, over a maximum of five years, to the borrowings model where assets are financed wholly through debt.

Figure 3 (below) shows the total debt that will be acquired over time as well as the debt servicing costs. Total debt will rise to around \$292m over 10 years, while debt-related expenses (mostly interest, but including loan application fees and legal costs) will be just under \$32m per annum.

Figure 3: Total debt and debt servicing costs



Source: Sapere analysis

The borrowings model predicts a substantial debt load for the sector having major implications for payouts. Although the results show that over the next 10 years there is a relatively modest difference in payouts of around \$30m, this result is misleading because it does not account for the debt being amassed. Assuming that a gaming machine society was wound up after 10 years, under the retained earnings model, the machines would be sold off and the proceeds distributed as grants. Under the alternative scenario, the gaming machine society would have to pay off its debt and there would be no further distribution.

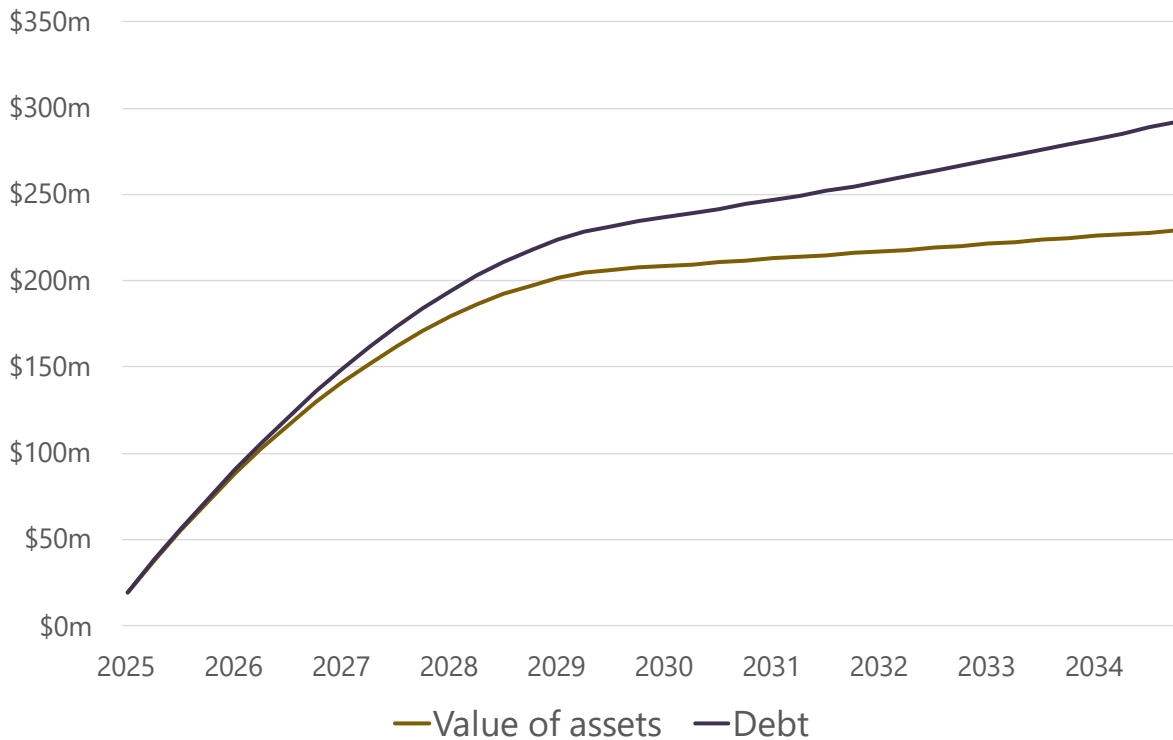
Our modelling indicates that debt rises faster than the value of assets, as the gambling equipment depreciates more quickly than the principal repayments, assuming, as we have, that a table loan is used.¹ The increasing differential between debt and asset value introduces several risks and workability issues from a lending perspective:

- Lenders would be less willing to extend credit to gambling trusts if the collateral (i.e., the value of assets) was worth less than the outstanding debt.
- Even if lenders were willing to provide financing, the increased risk would likely lead to higher interest rates. This would result in even more excessive interest costs for gambling trusts and lower overall returns to the community.

Figure 4 compares the total book value of assets acquired under the borrowings model with the outstanding debt across the sector through time.

¹ We have been advised that a table loan is the standard form of loan for these circumstances.

Figure 4: Estimated value of new assets acquired vs. debt in borrowings model across sector



Source: Sapere analysis

Overall, gaming machine societies would incur extra costs of \$232m in a 100 per cent borrowings model over 10 years. These extra costs will ultimately reduce payouts in grants by the same amount. These costs consist of:

- extra interest costs of \$215m
- loan application fees of \$10.7m
- legal fees of \$6.5m.

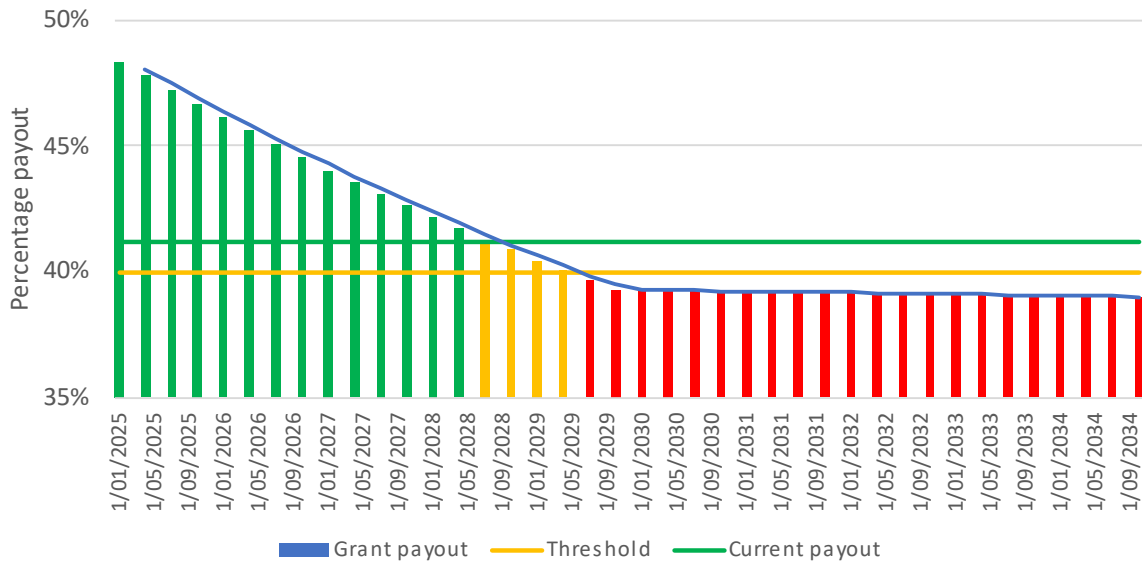
Expressed in real dollar terms, the total value of reduced grants is \$176m.

The costs in year 10 are \$31.6m and are comprised of:

- Interest: \$29.8m
- Loan application fees: \$1.2m
- Legal fees: \$0.6m

These extra costs will not be evenly spread across the forecast period. Counterintuitively, payouts in grants would increase above the current payout of 41.2 per cent of gross proceeds before falling below the current payout after three and a half years (as shown in Figure 2). One year later, the payout percentage would fall below 40 per cent, before stabilising at 39 per cent. Figure 5 illustrates how the percentage payout would change over time assuming stable machine numbers in the industry.

Figure 5: Estimated grants payout (percentage of gross proceeds) under 100% borrowings model by quarter



Source: Sapere analysis

2.4 Sensitivity analysis

We have varied two key assumptions to test the results:

- Interest rate
- Cost of machines

In Table 2 we show that the results of alternative input assumptions would produce a range of results between \$162m and \$500m. The modelling is sensitive to the interest rate available to gaming societies and the total costs of providing gambling facilities. However, it is a question of how big the total effect is rather than “is there a material effect”?

Table 2: Additional costs to gaming industry from new rules interpretation over 10 years (nominal dollars)

Interest rate/cost of machines	\$26,000	\$30,000	\$35,000
8.00%	\$162m	\$186m	\$216m
10.77%	\$202m	\$232m	\$270m
13.50%	\$252m	\$290m	\$337m
20.00%	\$373m	\$429m	\$500m

3. Conclusion

If gaming societies must fund asset purchases (particularly gaming machines) from debt and not from retained earnings, their cost of doing business will increase and the distributions to grant awardees will decrease. The increase in costs is equal to the sum of:

- interest costs
- legal fees
- loan application fees.

The nominal value over 10 years of these cost increases is \$232m. In real terms (2024 dollars) the value is \$176m. Initially grant disbursements will increase. But, over time, interest costs, other costs associated with lending, and debt repayments will result in a permanent reduction in grants.

References

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The Treasury. (2024). *Discount Rates and CPI Assumptions for Accounting Valuation Purposes*.

<https://www.treasury.govt.nz/information-and-services/state-sector-leadership/guidance/reporting-financial/discount-rates/discount-rates-and-cpi-assumptions-accounting-valuation-purposes>

Appendix A Trust financials

Trust	Grants payout (percentage of gross proceeds)	Annual report	Period ending
Air Rescue Services Limited	41.3%	https://www.airrescueservices.co.nz/public/ARSL%20Signed%202024.pdf	Jun 2024
Aotearoa Gaming Trust	39.0%	https://www.agt.nz/download.php?file=1715816339_2023%20Annual%20Report.pdf	Dec 2023
Blue Waters Community Trust	46.9%	https://marcomanagement.co.nz/wp-content/uploads/2024/07/BWCT-Financial-Statement-Year-Ended-2024.pdf	Apr 2024
BlueSky Community Trust Limited	43.0%	https://www.bluesky.org.nz/resources/pdf/Audited%20Financial%20Statements%20for%20the%20Year%20Ended%2031%20July%202023.pdf	Jul 2023
Constellation Communities Trust Limited	40.8%	https://www.constellationtrust.org.nz/files/ugd/719fb7_84bff14b32254ac48e9c47d69a4c55ad.pdf	Dec 2022
Dragon Community Trust Limited	42.6%	https://www.dragon.org.nz/images/pdf/GM2052502_2_Audited%20Financial%20Statements.pdf	Mar 2023
First Light Community Foundation Limited	41.9%	https://irp.cdn-website.com/c0191d48/files/uploaded/Summary%20Financial%20Statements%202023.pdf	Mar 2023
Four Winds Foundation Limited	40.1%	https://www.fourwindsfoundation.co.nz/wp-content/uploads/2024/08/2024-Summary-Financial-Statements-Signed.pdf	Mar 2024
Grassroots Trust Central Limited	40.3%	https://www.grassrootstrustcentral.co.nz/wp-content/uploads/sites/3/2024/09/GTCL-Annual-Report-2023-.pdf	Jul 2023
Grassroots Trust Limited	42.1%	https://www.grassrootstrust.co.nz/wp-content/uploads/2023/06/Grassroots-Trust-Annual-Report-2023.pdf	Mar 2023
ILT Foundation	51.8%	https://www.iltfoundation.org.nz/wp-content/uploads/2024/05/2023-Financial-Statements-signed-stamped.pdf	Mar 2023
Kiwi Gaming Foundation	41.6%	https://www.kiwigaming.org.nz/images/KGF-AnnualReport2024.pdf	Mar 2024

Trust	Grants payout (percentage of gross proceeds)	Annual report	Period ending
Mainland Foundation Limited	44.1%	https://mainlandfoundation.co.nz/wp-content/uploads/2023/10/Signed-Summary-Annual-Report-Mainland-Foundation-Ltd-FY23-for-Website.pdf	Jul 2023
Milestone Foundation Limited	41.8%	https://www.milestonefoundation.co.nz/uploads/2/5/6/7/25671094/milestone_foundation_annual_report_fy_jun-23.pdf	Jun 2023
New Zealand Community Trust	40.5%	https://www.nzct.org.nz/documents/148/NZCT_Annual_Report_2023_v14_100124.pdf	Sep 2023
One Foundation Limited	40.0%	https://onefoundation.nz/images/AnnualReport%202022-2023.pdf	Jun 2023
Oxford Sports Trust Inc	42.3%	https://www.oxfordsportstrust.org.nz/2023.pdf	Jul 2023
Pelorus Trust	41.2%	https://www.pelorustrust.net.nz/fileadmin/documents/2023_Financial_Statements.pdf	Sep 2023
Pub Charity Limited	41.0%	https://www.pubcharitylimited.org.nz/assets/Annual-Accounts-2023.pdf	Sep 2023
Rano Community Trust Limited	41.4%	https://rano.org.nz/wp-content/uploads/2024/02/Summarised-Financial-Statements-for-the-Year-Ended-31-July-2024.pdf	Jul 2023
Redwood Trust Incorporated	42.7%	https://www.redwoodtrust.org.nz/s/2023-stamped-audited-financial-statements-Redwood-Trust-Inc.pdf	Mar 2023
The Akarana Community Trust Limited	40.3%	https://www.akaranacommunitytrust.co.nz/wp-content/uploads/2023/06/002-Audited-Financial-Reports-2023-with-Auditors-report.pdf	Mar 2023
The Lion Foundation 2008	40.0%	https://lionfoundation.nz/News/annualreport2024/	Mar 2024
The North and South Trust Limited	42.1%	https://www.nstl.co.nz/wp-content/uploads/2024/06/Summary-Audited-Financial-Statements-FY-31-Mar-24-Signed-24-June-24-AUDITED.pdf	Mar 2024
The Trusts Community Foundation Limited	44.3%	https://ttcfltd.org.nz/wp-content/uploads/2024/10/2024-Financial-Statements.pdf	Mar 2024

Trust	Grants payout (percentage of gross proceeds)	Annual report	Period ending
Trillian Trust Limited	41.9%	https://www.trillian.co.nz/site_files/25012/upload_files/AnnualReport2023.pdf?dl=1	Jul 2023
Trust Aoraki Limited	39.9%	https://trustaoraki.co.nz/wp-content/uploads/2024/10/Trust-Aoraki-Ltd-2024-Summary-Financial-Signed.pdf	Mar 2024
Trust House Foundation	42.3%	https://trusthouse.org.nz/wp-content/uploads/2024/01/3.-THF-2023-financial-statements-including-signed-audit-report.pdf	Mar 2023
We Care Community Trust Limited	40.0%	https://wecare.org.nz/wp-content/uploads/2024/04/Summary-Financial-Statement-2023.pdf	Dec 2023
Youthtown Incorporated	38.3%	https://www.youthtown.org.nz/asset/downloadasset?id=9593b945-d2b4-481c-9c0a-1d61ac8f4235	Jun 2024

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