



RUSSIAN ROULETTE

IS VLADIVOSTOK, RUSSIA, THE NEXT IMPORTANT GAMING DESTINATION IN ASIA? By Dean M. Macomber and Steve M. Galloway

Vladivostok, Russia, a city much closer to Beijing than Macau and bordering northern China; a city in which President Vladimir Putin has spent over \$18 billion over the past four years improving and building; the incredibly strategic southernmost port city in Russia, has opened its doors to the world to develop the integrated entertainment destined to be a world-class casino-resort destination serving northeastern Asia, and in particular, northern China.

All you have to do to understand its potential is look on a map. However, there is no buzz in the industry, and operators are quickly missing the next new gaming destination in Asia.

To Understand Vladivostok Is To Understand Macau

While it may seem counter-intuitive, it is difficult if not impossible to discuss Asian gaming without those listening relating other potential venues to Macau, the clear Asian market and growth engine. So, to understand the Vladivostok opportunity and, frankly, to get excited about it, is to understand the basic dynamics of Macau.

Macau generated annual gross gaming revenue of US\$34 billion in 2011, approximately 5.5 times greater than Singapore—Asia's second-largest gaming venue—and the Las Vegas Strip, the perennial capital of gaming before Asia gaming was awakened. Singapore and Las Vegas each generated annual gross gaming revenue in the US\$6 billion range last year.

But of late, the gaming revenue growth rate in Macau has been falling dramatically, causing many to revise their 2012 annual fore-

cast downward from the 20 percent range to between 10 percent and 13 percent. This after Macau experienced a 42 percent year-over-year annual growth rate in 2011.

The causes of the drop off are numerous and complicated, but suffice to say that the slowdown may be largely attributed to deeper and deeper penetration of the southern and central coast People's Republic of China (PRC) feeder markets perhaps beginning to reach some resistance levels, the economy of Asia cooling from superheated GDP growth rates to what appears to be a current and more sustainable 7 percent or 8 percent annual growth rate and, arithmetically, simply that the denominator (base year annual gaming revenue) has grown so large that the same percentage gains become more difficult.





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Meanwhile, in a competitive arc that extends from Shanghai to Hainan Island around to the southernmost and western PRC border, existing gaming venues are expanding (e.g., Philippines), new gaming venues are getting ready to open (e.g., Ho Tram in Vietnam), and just about every other country contemplating the expansion or startup of casino gaming (e.g., the offshore islands of Taiwan) is hoping to capture a major if not a plurality of total demand from the PRC.

Everyone wants a piece of Macau's action, and that action is largely driven by the PRC feeder markets: approximately 58 percent of total Macau visitors year-to-date are from the PRC, and many estimate they generate 70 percent of the total gaming revenue. This said, while such numbers are not published, straw surveys would indicate that only 10 percent or so of Macau's annual gaming revenue comes from Beijing and PRC locations north and northeast of Beijing.

A Clear Commercial Opportunity Obscured By Fear And Loathing

While these events are occurring to the south, rather quietly—perhaps too quietly—by quirk of geography (Whoever knew that there was a city in Russia that is the same latitude as Boston, Massachusetts, and closer to Beijing than Macau?), a new gaming venue is poised to erupt and become the closest gaming market to northeast PRC—and become Asia's newest gaming destination.

Unless the PRC allows casino gaming within its boundaries—something no one believes will occur in the foreseeable future, if ever—no other place, *none*, can or will be able to get closer than Vladivostok. Unlike Macau, the number of alternative country venues that can take aim at the northeast PRC feeder markets is limited for all practical purposes to two: South Korea and Japan.

South Korea is about equidistant to Beijing but farther away from the three provinces to the north. Furthermore, South Korean residents are prohibited from gaming in any of the 17 South Korean casinos except one which is a four or more hour drive (takes the same amount of time to go to Vladivostok) from Seoul.

And so, South Korea becomes a feeder market to Vladivostok. Meanwhile, Japan currently does not allow casino gaming and has been discussing

legalization for what seems forever. As such, it remains another feeder market to Vladivostok until it does. Even if Japan were to open casinos and South Korea were to allow locals to gamble, this would not preclude the potential success for Vladivostok due simply to its location.

Gaming Market Advisors (GMA) conducted a situation analysis and market assessment for Nash Dom Primorye (NDP), the 100 percent-government-owned company responsible for developing the integrated entertainment zone (i.e., gaming zone.) GMA projected annual gaming revenue at a minimum \$1.3 billion in the startup period and \$5.2 billion after the market fully matures. This would clearly rank Vladivostok as a major, second-tier Asian gaming venue.

Were this new gaming venue located in a first-world, "sanitized" environment, there would be a line twice-around-the-block of gaming companies and investors clamoring for a casino license and a chance to invest. But so far, there is not. Putting a twist on the idiom "bull in the china shop," those in the fray seeking to develop a casino in Vladivostok know it is not a bull but the Russian bear that is holding interest back, the fear of doing business in Russia.

Doing business in second- and third-world countries means evaluating the risk of doing business in that country and determining if the potential benefits align or outweigh the risk. It is perplexing, therefore, why Russia is perceived with such fear by those who know other Western and international gaming companies are currently doing business in Russia as you read this article.

It is perplexing knowing the risks of doing business in other Asian countries as objectified by indices that measure such matters, e.g., the transparency index and the World Bank Doing Business Ranking where Russia is clearly found among the higher-risk countries, but no higher than other countries where gaming is taking place or being discussed.

It is therefore perplexing why gaming investors and operators would not sit down and calmly and factually evaluate the risk, as there truly is a limited number of actual and current opportunities to expand in or enter Asia. It may be argued that companies owe to themselves and their stakeholders to take the time to identify the risks associated with a Russian/Vladivostok casino project, separate fiction from fact and what is in the past and what is current, and determine which real risks can be eliminated, reduced, and/or managed so that the actual residual risk can be related to the upside benefits.

Only then can one determine if the risk-reward profile is favorable and



Of the four Russian gaming zones, only Vladivostok has infrastructure and a huge population nearby.



Vladivostok improvements include two new Hyatt hotels, a new aquarium and two world-class suspension bridges shortening drive time.

suits the temperament of the investor/operator. Put another way, if you are a gaming company, you owe it to your stakeholders to properly evaluate the perceived risk that many associate with Russia. Vladivostok deserves a look for the above reasons as well as others that will become apparent as you read on.

Getting To Today

Two major events brought gaming to Vladivostok. The first occurred in or about 1860 when Russia occupied the peninsula upon which Vladivostok is found, which heretofore was China. This event eventually led to the creation of Russia's easternmost port to the Pacific. It also on the other hand denied the PRC the same opportunity, thus creating a going-forward opportunity to now be of strategic assistance to the PRC and other northeast Asian countries.

The second event began in 2006 when Putin, in an attempt to clean up corruption and without warning, announced a change in the gaming law which limited gaming to only four specific regions in the country—of which not one contained an operating casino at the time.

The revision of the law came to fruition when, in July 2009, allegedly over 40 casinos and thousands of slot machines closed in Moscow alone. Of the four gaming zones, Primorsky Krai, in which the Vladivostok gaming zone is located, has the most strategic value to an international gaming operator. (The other three include Kaliningrad, located between Poland and Lithuania; Krasnodar Krai, a province that abuts the Black Sea; and the Altai region of Siberia.)

So far, the only casinos to open in the new environment are two in Azov City in Krasnodar Krai, and they are minimal casinos designed to primarily serve the local/regional communities. Vladivostok will be the second gaming zone to open a casino and, because of its proximity to well-populated and healthy economies driven by Asians with a high proclivity to gamble, is expected to emerge as the largest and most productive gaming zone of the four.

In Primorsky Krai, Putin personally decided where the gaming zone, or integrated entertainment zone as it would come to be named (IEZ), would be located. Beneficially, the IEZ is "huge"—650 hectares or 1,605 acres—and has heavily forested rolling hills that descend upon a fresh-water lake that overlooks a beach and the inlets that push in from the Pacific Ocean. It is a

resort waiting to happen, in this case a casino-resort. It is 20 kilometers from a new airport terminal, runway, and landing/safety equipment capable of handling the largest aircraft flying today—and 50 kilometers from the city of Vladivostok, a city of some 600,000 people.

Meanwhile, another political initiative was taking place which, long term, will be as important to gaming in the IEZ as the gaming policy—i.e., the decision by Putin to designate the greater Vladivostok area as an economic growth area for Russia. This realizes the importance and potential of a Pacific port to Russia, but also to Russia as a port serving other Asian countries, notably the PRC. Putting the "money where his mouth is," Putin committed and has spent US\$18 billion of the planned US\$20 billion in infrastructure improvements over the past four years.

This has led to the new airport, highways, a dedicated rail line from the airport to downtown Vladivostok, road improvements, two new iconic, world-class suspension bridges shortening drive times, a large new university campus, a new opera house (the second largest in Russia), a new aquarium, two new Hyatt flagged five-star hotels, and the gaming-driven IEZ. Whereas in other Asian gaming venues future infrastructure is more of a government "promise" than action, in Vladivostok the infrastructure improvements have been completed or will be completed in time for the APEC Meeting to be held there this month. Russia is not developing the IEZ to generate taxes; it is doing it to add to its image as a respected international city to which people would desire to travel.

The remainder of Primorsky Krai, or its less formal name, Primorye, has a total population of approximately 2 million, less the 0.6 million that domicile in Vladivostok. That means that approximately 1.4 million live outside the city area. While spread out over 64,000 square miles, all are within varying driving and bus distance—which is important, because Russian residents are allowed to gamble.

How Can The Chinese Get To Vladivostok?

Today, there are direct flights from Beijing and Harbin to Vladivostok. Although previously limited in number, an "Open Skies" agreement was just signed by the PRC and Russia which will allow for significant growth in air access. With the new airport now complete, passengers could arrive on the newest and greatest 747 and quickly go through immigration. In addition to flights, tourists can come by both car and train. It is important to realize that due to these regions' proximity, northern China and Vladivostok have had a working relationship for a long time. It is common for Russians to drive to the border to go shopping, and many Chinese come to Vladivostok for work

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and tourism. This relationship is further appreciated when traveling through northern China, where many signs are in both Russian and Chinese.

Visas for the Chinese to come to Vladivostok are relatively easy. It is important to remember that visas are a way of life in this part of the world. This is acutely true of travelers from the PRC, because they need an exit as well as an entry visa. Exit visas from the PRC are generally granted for government, business, and group-related travel, the last category comprising the bulk of foreign travel. Entry visas are needed by visitors into Russia.

Today, visitors from the PRC can enter, without a visa, in groups of five to 50 people arranged by tour operators established in China. Based on discussions between the two governments, it is expected that in the near future, travelers from the PRC will be able to enter Primorye Krai for 72 hours without any visa, providing travel is for leisure purposes.

In China, exit or entry visas are as much law as practice, law as much as policy, and to be totally candid, law as much as means and ways found to work the system. As found in Macau, the figurative spigot of visitors from the PRC can be twisted wide open or closed by degree by the PRC government, presumably to achieve a goal (open the spigot) or to make a statement (closing it).

But, as also found in Macau, third-party VIP room and junket owner/operators seem to have little trouble in getting their players from the PRC to Macau individually or in groups. Beneficially, there is a well-established history of travel between northeast points of origin in the PRC and Primorsky Krai. Discussions with the Russian tourism authorities in Primorsky Krai indicate they clearly understand their mission: to make entry to Russia as convenient as possible.

There is a fourth category for individual travel that needs to be considered, which today only applies to travel to either the Hong Kong Special Administrative Region or Macau Special Administrative Region, and only from designated points of origin from within China, the individual visit scheme (IVS). Where applicable, this makes travel from certain regions in the PRC to Hong Kong and Macau for Chinese citizens relatively easy. Over the years, the PRC has continued to expand the IVS program. Considering the long and healthy relationship between northern China and Primorsky Krai and considering the large strides made in recent years to improve trade and tourism between the two regions, the potential for an IVS to be developed to Vladivostok exists.

What is the IEZ?

The IEZ, short for integrated entertainment zone, is the government's name for the gaming zone to be developed in Primorye Krai. The forested hills at the southeastern end roll down toward a sea-level fresh lake followed in short distance by a beach overlooking the inlets from the sea, and at the far eastern end more abruptly end in cliff-like overviews of the same inlets.

The aesthetics of Vladivostok give developers a rich basket of resort elements to make a world-class destination resort: hills, trees, lakes, beaches and finger lets of land reaching in and around the inlets. However, in Russia, it is important to remember that Vladivostok shares the same latitude as Boston. In the summer it is a popular resort destination for Russians due to its sheer beauty, warm weather and warm water. In the spring and fall the weather is pleasant like the Northeast United



Vladivostok, Russia, a city much closer to Beijing than Macau and bordering northern China; a city in which President Putin has spent over \$18 billion over the past four years improving and building; the incredibly strategic southernmost port city in Russia, has opened its doors to the world to develop the integrated entertainment crucial to the success of any gaming destination.

States, and in the winter the cold does not approach the pain felt in Moscow and other regions for which Russia is renowned.

Nash Dom Primorye (NDP) is clear in its intent, i.e., to develop a world-class destination casino resort that will do for Vladivostok what gaming seems to have done for Singapore—drive visitors. To that end, NDP has master-planned the site and carved the overall site into three phases. The first phase comprises 12 parcels: nine hotel and casino parcels, one hotel and aqua park parcel, one yacht club, and one utility parcel. The second phase comprises another 11 parcels: three hotel and casino parcels, one hotel and aqua park, four hotel-only parcels, one guest villa parcel, one retail/exhibition/downhill skiing parcel, and one administrative center. The parcels range in size from the smallest at approximately 6 acres to the largest in the 40-acre range. Developers are allowed and encouraged to combine parcels.

Each parcel is accompanied by a stipulation of use (casino and hotel, hotel only, other resort activities and support; minimum capital investment; quality rating—3- to 5-star hotel rating—and minimum number of rooms). However, the government-imposed requirements are amazingly low, allowing the owner/developer/operator great flexibility to right-size the initial phase and subsequent expansion phase to their sense of initial market potential and risk. This development policy is the polar opposite to just about every other recent Asian gaming venue where the governments have demanded full build-out minimum capital requirements of US\$1 billion, sometimes with the capital or a substantial portion of it to be constructed in phase 1. In the IEZ, across all casino, hotel and villa sites, the average minimum capital cost per acre is in the low US\$4 million range.

Federal gaming law does not limit the number of gaming licenses that can be issued, choosing rather to only specify the size of the gaming zone (similar to legislation in Colorado). The initial phases of the IEZ contemplate developing some 21 sites for active resort use. However, not all of these are for gaming, and it is expected that developers will combine sites. Most observers believe there will ultimately be between five and 12 casinos operating on the IEZ.

There is still quite a bit of area not master-planned. However, golf courses have been discussed. Depending on the level of success, it could include more casino, hotel, and other such related development. Recently, the government

has shown some willingness to discuss phasing development to ensure an orderly and profitable evolution to full build-out.

Besides the low minimum capital requirement and large parcel sizes, perhaps the greatest "gift" the NDP gave future casino developers is a fixed per-unit-based gaming tax rate. This is huge, because once a casino pays the minimum per-unit tax, the tax "disappears," and all of what would have gone to tax in other jurisdictions flows right down to the bottom line. Based upon GMA gaming revenue projections and the established fixed tax rates, the gaming tax amounts to 3 percent-7 percent of forecast gaming revenue, a remarkably low rate when compared to the 39-plus percent variable gaming tax rate in Macau and 15 percent to 25 percent variable tax rates found elsewhere throughout Asia. Such a low tax rate provides owners/developers great scope to employ incentive marketing programs to drive business to Vladivostok when needed, but pocket the difference as added profit when not.

Like most emerging gaming venues, it has taken some time for the IEZ to get to this stage. There has been much discussion and the involvement of world-class consultants, master planners, engineers and the like contributing to the process. During this period, three land leases have already been signed and two casino licenses have been granted. In fact, one casino is already under construction that is said to be intended to cater to regional and local players.

NDP has chosen to issue all future licenses, however, through a transparent, Request for Concept (RFC) process. The RFC open-bidding phase is already under way with the RFC dated July 12, 2012, and RFC responses are due on or before September 21.

RFC proposals will be evaluated, and the NDP has chosen to leave it to their discretion whether to begin negotiations with those at the top of the respondents after the RFC deadline has passed or in a second and final phase to ask respondents to submit a more specific RFP response, rank order those responses, and begin negotiation. To its credit, NDP states very clearly that all parties must comply with the anti-corruption provisions of the Russian Federation and Primorsky Territory, and has pledged that the RFC/RFP process will be transparent with rules followed to the letter. A good example of this already in action is the listing of the parties who have already signed a land lease and/or received a casino licenses in the appendix of the RFC.

Sources Of Business And Forecast Results

GMA in its market assessment prepared for NDP provides a peek into the future financial potential of IEZ combined casino revenue, as well as how an individual casino might perform. GMA begins with a fairly detailed introduction into feeder market population size, demographic makeup, employment levels, income, and other demographic, economic and psychographic data. GMA also goes into some detail in reviewing the competition.

Perhaps the most telling portrayal of the marketing dynamic for Vladivostok is the market area within 600 km ring (approximately 373 miles) and another 1,200-kilometer ring (746 miles) around Vladivostok, Hong Kong and Singapore. Vladivostok will serve the northeast Asia marketplace, including the Greater Beijing Metropolitan Area, the three

PRC provinces to the northeast and including South Korea, Japan, and parts of Russia. To the benefit of Macau, the 1,200-kilometer ring shows that Vladivostok need not compete with Macau for the central and southern PRC coast or with Singapore to be successful; it is a northeast Asia play.

But cutting through the underbrush of feasibility-study brick-by-brick analyses that leads to a final demand projection, for the sake of brevity let us cut to the projections: Vladivostok is a market that will easily generate over \$1 billion today if developed properly, and has the potential to reach \$5 billion-plus with the stars aligning, which they seem to have been doing for the past four years. (Note: the full GMA situation analysis and market assessment along with other useful data is available to all bidders once they have registered for the RFC process on NDP's website, www.iczprimorye.com.)

It's A Wrap!

The IEZ in Vladivostok presents a real and now opportunity to enter Asia for those gaming companies not already there, and to expand in Asia for offensive and/or defensive reasons for those who do. Offensive reasons include getting closer to the underserved northeastern Asia marketplace to better nurture existing customers in these locales and to expand the database developing new players from this region. Defensively assumes that if you do not do this, one of your competitors will.

No doubt there is country risk in developing and operating a gaming project in Russia. Russia today is not the Russia of yesteryear, however. It will have joined the World Trade Organization by the time this article comes to print. There is a pro-business attitude growing in Russia supported by a recognition that it cannot continue to do things "the old way" and still maximize its growth potential. And, Russia of late is finding that it cannot rely so dominantly on its raw minerals and resources to drive its economic growth.

But, regardless, the low minimum capital requirement, the extremely favorable fixed and low implied rate of the gaming tax (a per-device fee which will likely approximate 3 percent-7 percent of gaming revenue), and the large sites provide owners, developers and operators great scope to manage risk. In Vladivostok, there is no "gun to your head" to build a \$1 billion property; rather, you can enter the market at a level that balances your assessed risk-reward evaluation and then expand as quickly as your assessment of the gaming environment and understanding of actual market dynamics dictate. This is rare and a great offset to the actual residual risks of doing business in a country like Russia.

Vladivostok is an opportunity to be a part of Asia's newest gaming venue and the gaming venue closest to northeast PRC. Gaming companies cannot afford to not be in Asia. Equally so, an Asian gaming company should put itself in the best position to serve Beijing and the three provinces to the north of it, not to mention South Korea and Japan.

There are many who wish they entered Macau when the naysayers were saying "stay away." Now it is too late. Lessons learned. This should not be said of Vladivostok.

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Casino under construction