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Research Brief: Paving the Regulatory Future for IRs in Japan – May 2021

With current events still changing due to SARS-CoV-2 and other geopolitical factors, the status reflected below may be materially different as events change. For specific inquiries beyond the release date, please contact Global Market Advisors directly for real-time analysis and updates as events continue to develop.

As the world continues to face numerous challenges and rebounds from the pandemic, most countries around the world remain closed to outsiders. Japan and others throughout Asia are trying to find a way to reopen but have had to implement new restrictions and emergency orders. In Japan, these have been most recently extended until the end of May in numerous parts of the country. This is further complicated by the upcoming Olympics and the inability to host foreigner visitors into the market. Olympic-sized problems surround this event in terms of not just the general logistics of hosting the Games, which were supposed to be a shining moment for this proud country, but also the public sentiment that is growing against hosting the games. A recent online petition had hundreds of thousands of signatures calling for the cancellation of the event, with at least nine of Japan's 47 prefectural governors concurring with the petition. These issues further cloud Japan's recovery in general terms and with regard to the hospitality industry, especially on the tourism goals established by the government.

Integrated resorts are paramount to these tourism efforts in Japan. While the industry keeps pushing toward the October 2021 – April 2022 submission deadline, the path forward is widely in question, presenting challenges for operators, prefectures, and regulators combined. In April, the Casino Regulatory Commission ("CRC") released its initial draft of the regulations that will govern the market with up to three initial IR locations under the existing framework. The voluminous submission of regulations was given a month-long comment period, allowing for stakeholder review of the latest document in this long IR market journey that began over two decades ago.

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THE INITIAL FRAMEWORK

The initial set of regulations by the CRC was published on April 2nd. This provided just over one month for interested parties to reply with comments as the agency accepted commentary through May 9th. The hundreds of pages that were released provided challenges for review by Japanese stakeholders, as well as interested gaming operators that had to rely on translation to review the regulatory language. The translation process and associated narrow timeframe did not necessarily allow for a complete review of certain key issues. This is particularly true for those parties who may not be well-versed on the integrated resort timeline. Ultimately, these regulations (and any other additional regulations going forward) will come back to the interpretations of the statute and continue to provide guidance moving forward.

Many of Japan's regulatory concepts have closely followed the framework of Singapore, which was the last major integrated resort market to undergo such a competitive tender process. These concepts have been refined to reflect Japanese law and focus on the harmonious culture of Japan, but not necessarily evidence-based research. The following sections of this brief highlight specific issues that may still provide challenges to operators interested in the market:

CALCULATION OF FLOOR SPACE

Under the current regulations, integrated resorts must not have over three percent of total floor space associated with gaming, and this has been one of the main challenges and questions of interested parties. The concept of limited floor space was first introduced when Singapore limited its gaming floor space to 15,000 square meters. Japan has taken a similar approach that is based on a specified percentage. While major corridors within the gaming space are not included in the definition, it does include the administration and operational functions of the pit area. This area is made strictly for the operations of a casino, just as the cage, count rooms, cashier, and other parts are integral to the operations. Although patrons to the casino might interact with these functions of the casino, these patrons would not be able to physically step foot in these areas. Japan should consider removing this provision and not include pit space within the three percent calculation allocated for gaming.

LICENSURE

Japan is renowned as having one of the most straight forward licensure processes for most fields. However, Japan needs to restructure its gaming license process to allow a preliminary finding of suitability. These IRs are multi-billion-dollar developments, and for financing to occur, operators will need to have some assurance that they will indeed be found suitable for one of the three IR licenses before allocating resources to move forward with development. Japan's current structure does not allow for a preliminary suitability finding to occur, as the license will not be issued until the IR is about to open. Without the assurance of a license, any developer would be



wary of moving forward with construction and procurement processes for a complex, multi-billion-dollar facility.

Additionally, the licensure process is extraordinary lengthy for key employees, board members, and even normal employees with the amount of personal information requested. While it is important to ensure that only suitable individuals are part of the gaming enterprise, it should not be an overly burdensome task for a worker to obtain a license as it dissuades individuals from participating at all. Operators will already have a wide range of other items to consider in terms of getting staff trained to be a part of the gaming enterprise, and this may further challenge that effort.

Regardless, this issue really comes down to the ability for operators to proceed with the development knowing that a license will be granted once the development is complete. Operators, consortiums, and other financial partners will need the assurance that licensure will be granted by the government. It is also in the best interest of the CRC to ensure that groups who are found to be suitable for licensure should not be met with any challenges or surprises once a decision is made to issue the first three potential licensees.

CHIP HANDLING

The exchanging of chips is not allowed on the gaming floor. This means that individuals may not exchange or be provided chips from another individual unless they are direct relatives. This requirement is similar to a restriction that was initially put in the regulations in Missouri in the United States. This regulatory provision would not allow patrons to share chips while riverboat casinos were out on an excursion. Jurisdictions like Singapore have a threshold of SGD 10,000 that provides some level of low-dollar transfers to occur between patrons.

While the measure is well intentioned, it would not allow patrons of the casino to leave the gaming floor with any chips. This means that if a patron wants to leave to go dine, shop, or just take a break, they would have to cash out their chips and then have them reissued when they return. This provides a cumbersome experience for the guest who might only be leaving the gaming floor for a very short time. It could also leads to inefficiencies from an operational and guest perspectives, as the operator will need to cash out and cash in patrons regularly, requiring additional cage space or other additional measures to provide players a safe location to deposit their chips temporarily while they briefly leave the floor.

This provision also would prevent patrons from providing a chip as a tip or “thank you” to a dealer or employee. While tipping is not common practice in Japan, it is something that is customary in gaming jurisdictions around the world. It is part of the culture of a gaming enterprise and should be embraced as Japan welcomes this new form of entertainment.



All of these situations highlight the need to reconsider the regulations regarding chip handling. Furthermore, it will be a challenge for operators to make sure that players are not exchanging chips, that the chips are not leaving the gaming floor, and stop players from tipping. This provision should be modified after garnering a greater understanding of gaming floor operations in Singapore, Nevada, and other gaming destinations.

COMPS & GROSS GAMING REVENUE

Complimentary discounts, or “comps,” are another customary part of casino culture and a key function within the economics of a gaming business. This may include promotional play or other comped items provided during or before a player’s visit to the facility, such as a complimentary meal or overnight stay at the IR’s hotel. Japan has tried to limit any ability to allow these types of normal activities. In every major gaming jurisdiction, these items are treated as an essential cost of doing business. Freeplay is not free, and it is often one of the greatest marketing expenses for operators, particularly in jurisdictions with a high tax rate.

It is important to remember that any non-gaming amenity given to a customer on a complimentary basis would appear on the overall income statement as a “Promotional Allowance” and as revenue in the subject category’s departmental income statement. It is common for gaming operators to show two sources of revenue: “cash” and “comp.” Comped revenue is a line item that should be deducted from the gross revenue line item to determine net revenue (including net gaming revenue which is taxable in many jurisdictions). Comped amenities are a common function of the gaming experience. Like chip handling, complimentary items should be allowed as an essential part of the operations of integrated resorts in Japan, as they are in all other jurisdictions.

SECURITY OF THE OPERATION

Las Vegas eliminated the influence of organized crime in gaming long ago, and it is now run largely in part by multinational, publicly traded corporations. Organized crime has no place in any casino operation, and this is why they are held to such high standards in other jurisdictions when it comes to anti-money laundering, financial transaction rules, and avoiding other criminal activities by knowing the customer. Technology continues to aid in these efforts and will continue to advance in its abilities, as will be a key focus within each of these IRs, especially at any point of entrance into the casino floor. Japan’s policy would separate foreign visitors, who would have to show their passport, from locals, who will have to enter using the My Number Card in addition to the entry levy. This will aid in keeping organized crime out of the operations and off the gaming floor. The Yakuza continue to reign over parts of Japan but will not be tolerated by any gaming operator. With that said, this issue will require a collaborative effort by the operators, regulators, and government agencies to ensure a safe and secure environment. This is the responsibility of not only the operators, but of all interested parties.



DOES ANYONE HAVE THE TIME?

In Singapore, regulations mandate that a clock must be included on every gaming device. Japan is a highly technical culture in which, like Singapore, an overwhelming majority of people have some level of a mobile phone that also comes with a sophisticated clock. While a clock should be clearly visible within a gaming area, this is an unnecessary regulatory requirement. The Countermeasures against gambling addiction will serve as a solid foundation in partnership with the government and surrounding community to address the education, prevention, treatment, and rehabilitation for those that may develop a problem with gaming.

OTHER CONSIDERATIONS

While there are other items within the initial regulatory framework that could also be addressed, this research brief covers the more salient points that will dramatically limit operations and, in turn, revenue for the gaming enterprise. Operators will already be constrained by a higher tax rate, the entry levy requirement for locals, and a three percent cap on casino floor space. By further limiting the economic engine of an integrated resort, this limits the potential opportunity associated with the overall product. The regulatory framework announced last year caused one major operator to step aside and has made others second-guess their entry into what is still the best opportunity for gaming expansion in Asia.

Challenges remain in the public consultation of the regulatory structure. The CRC is still jaded by the 500.com scandal from 2019 that in part delayed the regulatory and selection timelines. Major jurisdictions around the globe maintain strong relationships between operators and regulators to understand how gaming operations can be impacted by an existing or emerging regulatory structure. There should be dialogue between all parties that respect their roles in the process. Good and strong operators also know that they are not there to run and dictate the regulatory structure.

To this same extent, regulators need to understand and listen to the perspective of how operators may be impacted by these and other regulations and then determine what is in the best interests of the market. Singapore and Nevada continue to have good relationships existing in this framework, and if done appropriately, Japan can look to achieve the same as it becomes the next major gaming market. It will be incumbent on the CRC to look toward operators in the market and key groups that understand how regulatory structures work in other major jurisdictions to forge the best path forward.

OUTSIDE FACTORS LIE AHEAD

While the regulatory structure continues to be implemented and the selection processes in the four current prefectures continue, other factors may interject themselves into the process. While



most point to the Olympics, hosted between July 23rd through August 8th, and the Paralympics, held from August 25th to September 5th, Japan continues to move around these two major events to conduct other important events in addition to the IR process.

The first of these other notable events is the election in Tokyo, which is set for July 4th for the metropolitan assembly. Many view that this election will set the tone for the Lower House races in the Diet which will be held in the fall. The Liberal Democrat Party (“LDP”) lost several seats in the last election held in 2017 when they squared off against Tokyo Governor Yuriko Koike. The LDP saw significant losses last time, which could be a signal for the future. In last July’s reelection of Governor Koike, the LDP effectively supported her candidacy. This event could be one of the signs that also point to the potential entry of Tokyo into the IR race. Assuming that the Governor’s political power remains strong and that she has a strong showing in a challenging Olympics, she will still need something else to point to that can assist in Tokyo and the greater Japanese economy’s recovery. A Tokyo-based IR may provide a model for long term growth, as it would infuse significant investment into the city bring tourism and jobs into the market. GMA has long believed that Tokyo will eventually enter the IR race.

Yokohama’s Mayor has long been embattled in the IR conversation and debate. Mayor Fumiko Hayahi is the first female mayor for the city and has been a long advocate for the IR development in Yokohama (which offers one of the best sites for an IR in the country). However, anti-IR political forces within the city continue to dominate the conversation and provide a strong opposition to the potential selection of an IR partner and the ultimate selection at the national level. The outcome of the upcoming election on August 22nd could impact the overall IR race and Yokohama’s chances to secure one of the three available IR licenses. Wedged between the Olympics and the Paralympics, Yokohama’s political structure will face a large test, and the IR debate is at the forefront in all of its discussions. Meanwhile, Yokohama’s RFP process for an operating partner continues to push forward.

The third major election event will occur this fall when Prime Minister Yoshihide Suga’s term expires, along with the call over the election in the Lower House of the Diet. Suga’s term officially ends on September 30th while the term for the Lower House ends on October 21st. This leaves a small window for the Election considering the other events that are occurring around Japan. Current polling shows the cabinet’s approval rating in the mid 30s. The LDP also recently suffered three losses at the end of April that included a loss in the Upper House in Hiroshima and Nagano Prefectures, in addition to a Lower House seat in Hokkaido. Scandals as well as the continued strain from the recovery and lingering effects of the pandemic continue to plague the Suga administration.



THE PATH FORWARD

The Japan IR process is at a crossroads again. It faces pandemic-related challenges which will leave a significant portion of the country under emergency orders through the end of May. It is also struggling to vaccinate its population and people remain frustrated after they have spent over a year in lockdown. As previously mentioned, it also faces the challenges associated with hosting the Olympics, but most expect that Japan will capitalize on the opportunity and hold a flawless event. However, this assumes that Japan will once again start allowing foreigners into the country, which is not currently the case (as only athletes are currently expected to be exempted from entering the country).

Only one month remains before the first set of regulations are released. With RFP processes in four locations already underway, it seems unlikely that the timeline will be extended again (as it was a year ago with a six-month extension). However, based on the number of challenges the country currently faces, a small, but short, delay does seem reasonable. With an additional three to nine months, many bidding operators would have the ability to visit their potential host jurisdictions – as many of these operators have been unable to do so in well over a year. Without their teams on the ground, these operators may be in a blind spot as they put forward commitments that may or may not be enacted due to a lack of discussion, awareness, or general ability in a market.

Many pundits saw the departure of some operators over a year ago as a warning sign that the potential for the market was being impeded. Some of the industry's premiere operators are now on the sidelines. With the right framework and available locations, a more robust process could occur that would entice these operators to reenter the market, bring strong developments to fruition, and maximize the benefit for all stakeholders.

While times are difficult as the world continues to deal with the pandemic and host of other geopolitical events, it is crucial that Japan focuses appropriately on this opportunity to keep the process moving forward. This should include a more thoughtful review of the regulations and how they would be operationalized in the three potential IRs in Japan.

The world has been put on pause several times since the start of the Great Shutdown. Another three to nine month delay would provide a better path forward as Japan and the rest of the world recovers from the pandemic. Japan has one opportunity to pave the way forward with integrated resorts – as well as one opportunity to do it right. Extending the timeline would allow it to proceed at a more manageable pace and may entice some of the operators or locations that have remained on the sidelines to reconsider the opportunity. Pushing the process forward under the current timeline may limit the ability to have Japan's desired outcomes met to create the next global standard for integrated resorts.



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