



Karina Firme

President and CEO

Hebara, the operator of the state lottery of Rio de Janeiro – Loterj

PGRI Introduction: Brazil is the largest country in South America, and the fifth largest in the world, both by geographical area and by population with over 192 million people. There is one national lottery operated by CAIXA, which is also the second largest government-owned bank in Brazil. There are 27 separate states in Brazil, some of which operate lotteries within the borders of their state.

CAIXA has approximately 11,000 retailers nationwide which sell lottery tickets among other services. That is a ratio of one retailer for every 18,000 people. By almost any measure, the lottery market in Brazil is not developed to its potential. Noticing that Hebara is achieving better results than any other Brazilian lottery, I reached out to Ms. Firme to help us understand the Brazilian market in general, and also to get some insight into how Hebara is transforming the Rio de Janeiro Lottery into the vital social institution that Lottery should be.

Paul Jason, Public Gaming: *Briefly describe the lottery and gaming market in Brazil.*

Karina Firme: The lottery in Brazil is considered by legislators and society as a whole to be a public service. Its purpose is to generate funding to support public interest causes. There is one lottery that is operated throughout the entire country, in all 27 states. This national lottery is run by a department of CAIXA ECONOMICA FEDERAL, the second largest government-owned bank in Brazil. CAIXA plays a crucial role in the financing of infra-structure, housing, and the management of public saving and social security. On the State level some states are also entitled to have their own lotteries, confined to the geographical limits of the state. Approximately half of the states had an operating lottery in 1967, when a presidential decree determined that only existing state lotteries were allowed to remain active, no other state lottery could be created. Of these, only 5 are actually in

operation (Rio de Janeiro, Minas Gerais, Ceará, Para and Paraíba). Recently there has been some movement to reinstate some of the state lotteries that are inactive.

Are the state lotteries typically run by the government or are most operated by a private corporation like Hebara in Rio de Janeiro?

K. Firme: The government of each state decides for itself which business model to implement. The government of São Paulo, for example, chose to run the lottery directly through a department of its own state bank, subcontracting only the printing of the tickets. Rio Grande do Sul has a more open model, with one-year licenses given to any operator which offers to run any specific lottery game within the state. In the case of Rio de Janeiro, the state has subcontracted the whole operation to a single operator (Hebara) with exclusive rights to run all existing lottery games in the state.

What do you see as some of the strengths and weaknesses of each lottery model?

K. Firme: There are different ways to measure lottery performance. All lotteries, whether operated by a government agency, a bank, or a private commercial company, must comply with all legal and regulatory constraints. There is typically an oversight group that ensures that the lottery is operated to the highest standards of integrity, security, operational effectiveness, and responsible gaming.

Performance of lotteries could also be measured by the financial and business standards applied to successful consumer products companies. Are the products evolving to keep up with changes in the marketplace? Are the games being refreshed and updated to appeal to the modern consumer? Is the marketing, advertising, and branding effectively communicating the fun and excitement of the games? The metrics used to assess performance in those areas would include revenue and sales per capita trend-lines, and net funds contributed to the lottery beneficiary, be it the government's general fund or some

other worthy causes. It is in these categories that private commercial operators tend to be more innovative and entrepreneurial and produce better results. While it is not for me to say which is the “better” model, I do think the facts speak for themselves as to the performance of different management structures. Government agencies and large financial institutions tend to be more administrative, more conservative, less entrepreneurial, less innovative, and less likely to hold themselves accountable to a best practices approach towards optimizing performance in the marketplace. Commercial operators like Hebara are incented to invest in the business and so make more of an effort to innovate and connect with the players, just like all of the best consumer products companies do. And we are held accountable and expected to reach much more ambitious revenue targets than are the government and bank operated lotteries.

The difference is especially evident in the Instant Tickets category. Instants need to be managed like any other consumer goods product, with constantly refreshed games and marketing, and a dynamic approach to all strategic planning. The culture and management structures of government agencies are not ideally equipped to operate in that kind of environment. For example, an RFP to hire an advertising agency can take up to a year, and the purchase of goods or hiring of services, no matter how small, has to go through a cumbersome process of public tenders. Furthermore, the officers at the state lotteries usually change with each change in government every four years. The result is that Brazil has very few lottery experts in public office.

Another measure of performance is alignment of public policy and responsible gaming objectives with lottery operations. In Rio de Janeiro, Hebara manages and operates the games. But the state acts as regulator, decides where the proceeds of the lottery will go, and exercises active oversight over the whole operation. Hebara does not have free reign to determine how to accomplish the financial targets set by the state. So, commercial operators are expected to accomplish much more ambitious financial objectives and yet always stay consistent with the agendas and public policy objectives defined by the state.

You mentioned that Rio Grande do Sul has an open model, but the operator license term is only one year. That hardly seems like enough time for any initiative to yield an adequate ROI.

K. Firme: Exactly. Add to that the lack of exclusivity and the result is lack of interest from serious operators who know that you can't really do business that way and expect to produce results that are meaningful for anyone. Short term licenses without exclusivity rights have the problems of low investment levels and work as an adverse selection mechanism. Serious companies would be unwilling to engage in the necessary steps to forming a retailer network, training its sales force, and marketing a product, without the guarantee of at least a few years to get the return on this investment. Then there is the burden of sharing an “umbrella” of reputation and credibility (which is the state lottery brand) with other unknown competitors who may have different standards of integrity and risk. The short licenses result in lack of investment in the business and a standard of lottery operation that produces mediocre results.

A couple examples: São Paulo had its state lottery shut down in 2009 when the state bank which ran the lottery was sold. In its final year of operation the São Paulo lottery sold R\$ 22 million. Rio de Janeiro sales were R\$ 189 million. Rio's sales were 8 times that of São Paulo even though the GDP of São Paulo is almost 4 times that of Rio! And Rio Grande do Sul has tried but not succeeded at developing a quality operator because, in my opinion, the one-year licenses are not attractive to serious companies and not conducive to the investment needed to create a retail network, do market research, design and test products, build brand equity, and do the things you need to do to develop the business.

The current contract term for Hebara to operate the Rio de Janeiro Lottery is five years. When did Hebara enter the lottery business?

K. Firme: Instant tickets were introduced in the state of Rio de Janeiro in 1990. The State issued an RFP and a group of entrepreneurs founded Hebara which subsequently won the contract to operate instant tickets in Rio. Hebara's responsibilities include de-

signing the games, distributing the tickets, developing and executing the marketing strategy. The whole business operation of the lottery in Rio was, and still is, under the responsibility of a single company which in turn has to meet sales quotas for the state.

How does the state determine sales targets and are there consequences (as in the form of charge-backs) for falling short of the sales quotas? And are there bonuses for exceeding quotas?

K. Firme: Sales Quotas are based on the growth rate that the state determines is ambitious but achievable. There are penalties for not meeting the sales quotas, which, depending on the level of sales, can be as high as 30% of the quotas. There are no bonuses for exceeding the quotas, but since the operator gets a percentage of sales as a fee, the operator benefits from higher sales levels.

The evidence would seem to be clear that entrusting the operations to a bank is not the best solution, and letting one year contracts makes it impractical to invest in the business. Further, the success of Rio de Janeiro with Hebara illustrates what can be accomplished if the state removes those obstacles and allows the lottery to be run like an innovative and consumer-driven business. So why don't other states do the obvious thing and replicate the RFP process that resulted in the superior operation of the Rio de Janeiro lottery?

K. Firme: Any hiring of services by any of the state governments in Brazil has to be through a public tender which is a cumbersome process. However, I think the main thing is that states have paid very little attention to the lotteries and have been largely unaware of the potential that lottery represents, simply unaware of the levels of sales and funding that is being generated by lotteries in other parts of the world. Add to this the fact that gaming and gambling in Brazil are still very much stigmatized and considered to be a sensitive industry. If you combine low expected revenues with a politically costly endeavor, it is not difficult to understand why this industry is under developed and why most state governments have not paid too much attention to the lotteries or engaged in RFPs. But

...continued on page 32

times are changing and I think that Brazil is making great progress in educating itself about the lottery industry, and will soon arrive at a more enlightened vantage point to make the necessary political decisions and regulatory changes.

The Brazilian market is severely underperforming. While CAIXA has started to be active in CIBELAE and participate in international events, it has been slow in acknowledging best practices, or to take a more proactive stance towards improving performance. Regarding the instant lottery, CAIXA's biggest distortion is the payout, which is currently at 28%. Its operation also suffers from lack of capillarity, unattractive game portfolio, and it has also "missed the wave" of higher price-point products.

Why doesn't CAIXA observe what is being done in Rio and attempt to replicate some of your success strategies?

K. Firme: To some extent, they do. We are essentially their only competitor even though we are confined to the state of Rio. They have adopted some marketing approaches that we use as well as new, non-cash prizes that we introduced in the market, such as cars, houses, motorcycles, etc. These prizes appeal to our target consumers and formed the basis for some very successful initiatives.

This is also a sensitive issue. CAIXA is the second largest public bank in Brazil, with total assets worth R\$500 billion (over US\$ 250 billion). It is one of the most important instruments that the government has to implement a wide variety of public policies. Lottery is only one of many responsibilities entrusted to CAIXA. CAIXA is the main vehicle for savings for the general population since it receives savings deposits which are fully guaranteed by the government. It is the institution that pays social security benefits (FGTS) and has for years been the main source of housing finance due to the lack of private financing instruments. In many ways, and for better or worse, CAIXA performs for Brazilians many of the functions usually reserved for the government.

The problem is that this is not the best context for a lottery operation. CAIXA is

beset by a myriad of demands, making it challenging to optimize performance in all the different areas. If you look at the breakdown of the CAIXA lottery revenues (<http://www1.caixa.gov.br/loterias/loterias/megasena/distribuicao.asp>), there are many different recipients of the sales proceeds (Olympic sports, Para Olympic Sports, Culture Fund, etc.) that actually come directly out of the Prize Revenues! When you factor this in with income taxes, the player is left with a net prize payout of only 28%. Apart from disbursements that come out of prize revenues, there are still other beneficiaries "above the line" which get a direct percentage of lottery sales proceeds. To the extent that lottery players contribute to the benefit of funding different public services with very little coming back to them as prizes, the national lotteries are effectively turned into a special tax that lottery players alone have the privilege of paying. It is not for me to speculate on how to change this structure. But it is for all of us in the industry to understand the implications of this structure and how it impacts the overall challenge of creating a healthy lottery business. I do think that at this point CAIXA is aware of this argument and that it would be reasonable to expect that they are presently exploring the ways and means making some changes, and of passing laws to change the revenue structure of the lottery.

Doesn't the weakness of the national lottery create a great opportunity for the state-run lotteries to deliver a better product and value to the consumer and thereby become the gaming provider of choice for the vast majority of consumers in Brazil?

K. Firme: I do believe that there is an opportunity for the states to complement CAIXA's operation. CAIXA will always have the comparative advantage in the jackpot games space, since it has the revenues from the whole country. That large scale is a vital component to the success of jackpot games and the individual states cannot really compete with CAIXA for that reason. However, I do believe that the states, with the right model, could capture a large share of the Instant and Passive

games markets. States have an excellent opportunity to build a superior operation and create games, prize structures, and marketing approaches that appeal to the consumer tastes specific to each region. And the funds they generate would go to support their own local beneficiaries.

I saw the term "poverty trap" in reference to Latin American lotteries. Could you explain what that means?

K. Firme: There is a great divide between the Latin American operations and the mature market operations of the USA, Italy, UK, France, and others like them. All the countries in Latin America suffer from very low levels of sales and rank below average in lottery performance. There are the very real economic constraints faced by lower income countries (and the even lower levels of DISPOSABLE income). The "poverty trap" you refer to is the syndrome in which low sales require a high % commission to attract retailers and a high % return to the governments. That results in a low prize-payout (avg 50%) to the consumer. This syndrome results in a perpetuation of low sales and makes it difficult to break the vicious cycle. We need to break this counter-productive syndrome of high % retail commission, low prize payouts, and low attractiveness of the product. These are things that must change to create a healthy and prosperous lottery industry in Latin America.

Additionally, in many cases including our own in Rio, the retailers are not equipped with terminals, and rely on manual (visual) validation. This prevents more interesting game mechanics and multiple chances in the same tickets because of the difficulty of checking winning tickets. Finally, because our products are sold and not consigned, few retailers are able to invest in the full product mix. We believe that terminals will allow the implementation of consignment or a credit policy that would facilitate retailer operations and enhance sales. We were just awarded a new 5-yr license and it is our goal to implement a terminal-based validation system and move towards a more effective management model for Rio.

What is the status of internet gaming in Brazil? How about Players' Clubs, social gaming, and some of the other phenomena happening in other markets around the world?

K. Firme: CAIXA has started to offer internet betting on its main game Mega-Sena, so far limited to CAIXA checking account holders through their internet home banking platform. They plan to do a roll-out to the general public once this initial test gets validated. Our current licenses in Rio do not allow internet gaming, I believe mostly due to the same restrictions that affect other markets (jurisdiction, controls etc...). This is an area where more is said than done, even by us. Being such an immature market we are still too focused on developing the traditional channels. But I am a strong believer in some of the Players' Clubs initiatives as a way to connect with the consumer and in using the internet and social medias as powerful feedback instruments.

What are some of Hebara's business priorities and near-term objectives?

K. Firme: In 2007 we started to study other countries to look for benchmarks for our instant lottery operation. We understood the importance of higher payouts as well as the structure of a prize schedule, with sweet spots, odds, heart-stops etc. We also started increasing our portfolio mix with the intention of appealing to different target groups. Additionally to our R\$ 1,00 portfolio, we launched R\$ 2,00 and R\$ 3,00 games. For 2 years we sustained almost 100% growth per year and our Instants sales in Rio are now 5 or 6 times that of CAIXA.

Up until very recently, technological constraints in Brazil (i.e. cost of hardware + communications) made it almost impossible to implement terminal-based validation systems in Brazil, at least for our local operation with a 5-yr license. Right now we are confident that we have a viable model to implement a Terminal Based Validation System, based on mobile communication technology and handheld devices which will allow us to:

- Implement consignment of products allowing retailers to carry a fuller product

mix without cash in advance

- Settlement of account balances with retailers via the banking system
- Lower retailer commission which is crucial to allow increases in prize-payout.
- Increase payout
- Implement a greater variety of game mechanics to attract a wider range of players.
- Implement higher price-point products
- Simplify the retailer operation to give us access to a more diversified retailer base
- Increase capillarity with a simpler, less risky operation – important for impulse purchase

We are currently running pilots to determine the best action plans and we expect to have the full project running by the end of the year.

In order to compete with CAIXA's jackpot games without the appeal of high prizes we understood that we needed to create a completely different format, based in intangible assets such as credibility and emotion. In 2007 we re-launched the weekly passive game under the name Rio de Premios, This format is anchored in a 30-minute live TV show on Sundays, which has been really successful and the product has enjoyed a steady growth since its launch. It's my pet project. This weekly draw game is a 20/50 matrix. We distribute around 1 million tickets every week and we collect the unsold tickets and process them (read the bar code) in order to determine which actual tickets and combinations were sold. Based on this we draw the 20 balls and if there is no winner among the sold tickets we keep drawing as many balls as needed to get a winner every week. We also have a slip on the ticket that gets filled out by the player and deposited in collecting boxes at the retailers containing their names, addresses and phone numbers. These slips are also collected and stored in a organized way so that during the live TV show we are able to contact the winner of the top prize. This produces a very emotional and exciting moment on live TV. In order to motivate players to deposit the slips (which is not mandatory), we give out many other

prizes such as houses, cars, motorcycles, cash prizes. These other prizes are given out by physical draw of the slips. Immediately after the show, the TV presenters go to the winner's house and tape a 3-minute very emotional video showing the winner's house, their family, why they needed that prize and what they plan to do with the money. This 3-minute video is then shown on the next program. Our TV program is currently the second highest audience ranking on TV at that time slot, on some weeks we are the top ranked TV show on that particular slot. The product enjoys very high credibility and a very strong emotional link with its consumers and has had an upward trend in sales since its launch in July 2007.

The challenges that we have been talking about seem to have inspired quite creative approaches on your part. Do you think you will be able to break out of the "poverty trap", and accomplish some or most of the objectives you outlined? And when you do, won't some of the progressive strategies that you developed in spite of current constraints (initiatives like Rio de Premios and creating new kinds of prizes) reach even more players, provide you with even more content to go with the improved distribution and consumer-connection, and become an even more impactful tool to drive sales?

K. Firme: Yes. I strongly believe that with the implementation of our new Business Plan we will enter into a virtuous cycle of growth, where higher sales produce more winners, which contributes to the word of mouth and brand perception and this in turn attracts new players and retailers. We will be able to develop a more diversified portfolio, with games that appeal to different groups of consumers. We expect that in the next 5 years we will have increased sales by at least 300%. Ultimately higher sales levels will allow us to better fulfill the lottery's mission and help place Brazil in a position regarding the lottery more consistent with the country's increasing relevance in the global scenario. ♦