



## Jim Kennedy

### Chief Marketing Officer Scientific Games Corporation

**PGRI Introduction:** The shift is happening slowly but surely. And it's seismic. The shapers of public policy are recognizing the power of their own government lotteries to generate funds to support the public interest, whether it is to fund the rebuilding of infrastructure and public works as in Illinois, to support scholarships for public education, or any one of the other good causes supported by lottery. Government lawmakers are more willing than ever to explore new ways to capitalize on the ability of lotteries to play an important role in the financial welfare of the people. This shift in political attitude towards lottery opens up the opportunity for lottery to step on the gas and really show what it can do. It's already happening – just look at the sales increases over the past year. As governments explore different management structure options like the Northstar Lottery Group's Private Management Agreement (PMA) in Illinois, they are also re-assessing the mandate that is given their own government-regulated lottery operation and asking the logical question: What if we allowed our own lottery to operate with the kind of entrepreneurial license that we would give to a PMA? I asked Jim Kennedy what lotteries might do if they had more flexibility to operate like a commercial firm. Of course, Kennedy is the CMO at Scientific Games, so the ideas just kept on coming.

**Paul Jason, Public Gaming:** *Outside of a start-up, the turnaround of instants in Illinois by the Northstar Lottery Group is probably among the best ever, isn't it? And it's an interesting example of how the application of best practices can produce remarkable results.*

**Jim Kennedy:** Exactly. The instants business in Illinois grew 27% or \$345 million in one year. This was the highest growth rate of instants in the U.S. other than California, which raised their prize payout. Illinois didn't launch a new price point; they didn't change their prize payouts. What they did was put a package together with an experienced team of lottery professionals to build a consistent product portfolio, manage the overall portfolio instead of individual products and aggressively execute with a well-conceived business plan. This included consistent game launches, strong core games and base games, extensions of games that the consumer was already fa-

miliar with, integrated advertising and promotions, controlled communications with retailers and the media, and a host of action items that were all part of a detailed and integrated business plan.

But we didn't just discover the secrets to success last year and just happen to have them ready to implement for the Illinois Lottery. Much of what we did with instants in Illinois has been understood by our company for years. And even now, much of what was done with Northstar could be applied to other markets and yet in many places it isn't. Everything we did was based on the leadership of an experienced team of professionals from the Lottery, Scientific Games, GTECH and Northstar. But you don't have to have a PMA to do these things. We are ready and able to implement these best practices for all of our customers all across the world. A PMA might require a leap of faith for the operator because it involves change and doing things differently from what has always been done. But

PMA's are actually based on a comprehensive application of best practices as they have been applied at the top-performing lotteries around the world and on a thoughtful and prudent decision-making process that is driven by scientific interpretation of the facts. PMA's require recognition that complex problems are best solved by a scientific approach. The tools to do this are available and their effectiveness is proven and demonstrable.

The decision-making process driven by a best practices methodology is not a linear calculus of just applying numbers to get answers. The analysis includes a holistic approach to inferring the meaning of the data and the experience of turning the results into an action plan. It is an integration of information pertaining to the local gaming culture and existing local environment. And it is the leveraging of this data that tells us what works and what doesn't work. This can make the difference between success and failure.

*Illinois went from multiple instant game suppliers to just one supplier, Northstar Lottery Group. Is that the best model for driving innovation, change and aggressive execution?*

**J. Kennedy:** Scientific Games' role in Northstar is to produce and distribute 100% of the instant games in Illinois. Most of the highest performing lotteries have a primary instant product relationship with a single supplier providing 80% or more of their portfolio of instant product. There is no evidence to support the idea that lottery needs a variety of partners to create "the next great game" if the suppliers are operating independently from one another. Lottery games must be managed and integrated like any other consumer product category. And when you look at the U.S. lottery industry, you'll find that last year Scientific Games produced more than 75% of the best selling instant games.

*That's interesting, because in our last issue, Paul Sternburg, Director of the Massachusetts Lottery, walked us through the process of evolving the design of an instant game for the purpose of increasing sales. It struck me that what he was describing was not so much individual 'games,' but a consumer product managed as a category.*

**J. Kennedy:** That is exactly right. The instant game is a consumer product category and a lottery's portfolio of instant games is best managed as a product category not a collection of individual games. Historical attempts to segment the marketplace into different demographic profiles and consumer

groups, and design and market individual games to appeal to those target markets, has proven to be an ineffective approach to instant product management, but it continues to be practiced when in most cases the lottery manages the entire category of the product not as brand within the category. The purpose of designing the instant game – and developing strategies to advertise, promote and distribute the game – is much better served by managing it as a holistic product category as opposed to a collection of individual games. Said a different way, instant games are an integrated category to be managed and positioned for overall performance, not as single products launched to capture the attention of segmented consumer groups. At Scientific Games, we refer to it as the instant product category, not the instant game category. This sets the stage for integrated development of the elements of the marketing mix and for the execution of an entire program for the instant product category. This helps clarify the unwieldy process of deciding which 50 games to bring to the marketplace over the course of the next 12 months and how to present the category to consumers and retailers.

The Massachusetts Lottery and Paul Sternburg have done a fabulous job doing exactly that. The result is that the lottery with the highest instant games per capita sales in the world, the Massachusetts Lottery, continues to increase its per capita sales. They set the bar higher than anyone and then they pass it. Gratta Vinci, the lottery in Italy, is another top-performer with the highest total sales of instant games in the world. Let's refer back to Scientific Games' best practices principle that there is more commonality to human behavior throughout the world than there are differences. Think about it: Massachusetts and Italy. These are two completely different marketplaces with two completely different gaming cultures, lottery operations and regulatory structures. And yet there are far more similarities between these two top-performers than there are differences. Most lotteries do not have nearly as high marketplace penetration. First, these two lotteries have the fewest number of game launches. Second, they manage the entire category for optimal overall performance. They make sure that products work well together and produce a synergistic result in the marketplace. They make sure games are on the street long enough for people to understand them. Everything they do is defined by the approach to marketing instants as an integrated consumer product category. Like

Coke, or Starbucks or McDonalds. What was the first thing Steve Jobs did when reviewing the product mix of Apple when he came back as CEO back in 1977? He slashed the number of products from something like 15 down to four. Effective benchmarking includes the observation of what works in successful businesses like these. When we can combine the direct evidence of what happens in our own industry – with two of the most successful lottery operations in the world, along with the experience of other top-performing lotteries – we can create quite a wealth of best practices to benchmark against. The principles that apply at the world's best consumer marketing companies like Apple and Coke, and at our best performing lotteries from all around the world, share many common attributes. We know what these principles are and how to implement them; our opportunities for growth lie in their execution.

*Increasing the prize payout seems to have worked wonders for the California Lottery.*

**J. Kennedy:** California was the last big state that had severe restrictions on prize payouts. Louisiana and Oklahoma are still restrictive and this definitely impedes growth. California grew \$700 million, or 35%, year-on-year in their instant business. That's huge growth. But this wasn't simply about increasing prize payouts. Having the flexibility to manage prize payouts to differentiate the products, adding value to the higher price point tickets and such, is the key. This flexibility enabled California to design games with other attributes that enhanced the entertainment value by putting more prizes in their games.

The average payout in the United States on instant games is about 67%. Based on research that Scientific Games has conducted in multiple jurisdictions, we think the optimum payout to generate the most net profit to good causes should be somewhere in the neighborhood of 72%. So right now we estimate the entertainment value at most U.S. lotteries to be a good five percentage points below what it should be to optimize net income.

*Don't we want to stagger the rate of increase of prize payout, dole them out in judiciously small increments in order to eke out maximum promotional value for the longest possible time?*

**J. Kennedy:** Like everything, prize payout needs to be managed properly. But it is a mistake to think of it as some kind of slippery slope that leads to margin erosion and

eats into net funds for good causes. Problems in profitability usually lie elsewhere. Look at Massachusetts, with the highest U.S. per capita instant sales at \$447. With a 77% prize payout, they have had the highest prize payout percentage in the U.S. for many years. But they also have one of the highest per capita net revenues. Insofar as the measure of performance is funds to good causes, Massachusetts ranks number one in the U.S. for this too.

The view that increasing prize payouts is a slippery slope has actually been around for decades. It dates back to when lotteries were starting up at the rate of two or three a year. There was the burst of enthusiasm with the strong early adoption. And then there was fall-off from the growth curve. We can contrast this era with lotteries that have started up more recently. Arkansas, for instance, is the most recent start-up and the Lottery immediately climbed to one of the highest per capita sales in the country. Scientific Games worked with the Arkansas Lottery to start with the best games, best designs, the best payouts – the best of everything in every way. We launched the Lottery with a loyalty program that allowed players to get value from their non-winning tickets. We've learned over the years that if you give the consumer the best experience, they will continue to support the retailers where they buy their games – and retailers will make the effort to generate more lottery sales so ultimately more dollars will be created for profits and more kids will receive a college education. And so what we see now in Arkansas, unlike what we saw back in the day when sales dropped off, is consistent and steady growth of their product category. The growth rate has settled down a bit, but there was no drop-off from that incredible burst of energy at the launch. The same was true of launches a few years back in Georgia and Tennessee. Hopefully under new leadership in Oklahoma there will no longer be restrictions that prevented the Lottery from launching this way and creating the necessary pull from consumers following their start-up phase.

*But how do you retain the attention of the consumer if you give them all you've got up front? Don't you want to manage the process so that you can create the perception of always giving players something more?*

**J. Kennedy:** First, if you are really giving them the very best all of the time, the consumer knows this, responds to this, and will have a level of loyalty that won't be so fickle and willing to tune out. Apple just focuses on creating great products – they have accrued a

loyalty based upon consumer perception that Apple is wholly dedicated to producing great products. A simple philosophy that works. Second, of course we do introduce new products and product innovations all of the time. As much as we focus on creating the very best products right now, we are also just as focused on continual improvement, always creating more exciting products to replace or augment the current exciting products. There is no reason to hold back, or stagger quality ideas in a misguided notion that this is the best way to get maximum value from each of them. Just go for it but keep working to create something even better. We are constantly creating new innovations like interactive 2nd Chance games, our For Life family of games, Micromotion™ printing techniques, electronic instant game bonus extensions and retail promotions. Scientific Games will continue to roll out exciting new product and promotional concepts. That's our job. We set the bar high and we are always working to surpass it. Because you're right, you must continue introducing new and exciting products to capture the imagination of the consumer.

Part of this is to recognize that much of the engineering is integrated into the games, things like the prize structure, patterns and price point mix, and the many elements that go into making a good solid game design. These are all fundamental to the category. But together, the artwork, the execution and the look of each game are a balance of new and familiar. It's a balance between the engineering that goes into the game and the aesthetics of the game. The families of MONOPOLY™, Lifetime and multiplier games are good examples of underlying engineering that is built on deep experience, yet the feel and play of these games is fresh and new.

*It has always seemed to me that lotteries could update their risk assessment model. The average net profit for commercial firms is around 6%. For lotteries, it's more like 30%. The upside potential for a good idea is literally five times greater for lotteries than it is for commercial companies. If lotteries can't assume the small downside risk in spite of the huge upside potential, why not outsource the risk to their commercial partner and pay for it with a small percentage in some form of profit-sharing arrangement?*

**J. Kennedy:** Of course, that is the basic principle of the Private Management Agreement (PMA) model. The Illinois-style PMA is currently being considered in states like Pennsylvania, New Jersey, Indiana and several oth-

ers. But the PMA is one of several ways to accomplish this. There are other ways to increase investment, to reshape the lottery's approach to be more sales focused. Scientific Games has Cooperative Services Programs (CSPs) and Properties Plus® programs that enable a lottery to outsource the risk and up-front investment in return for a share of the profits.

One way or another, we need to unlock the hidden value of lottery. As lottery suppliers, we have the tools to do so much more than the lotteries allow us to do. In Illinois, for instance, instants increased by \$345 million in the first year of the PMA. But there was nothing we did that we hadn't previously recommended to Illinois. They were focused more – as most lotteries are – on operations and controlling costs and, as you are pointing out, eliminating risk.

Application of effective consumer product category management and state-of-the-art player loyalty programs are two top-of-mind things that could add transformative value to most lotteries. The point is that state governments need to know that their own lotteries are capable of doing so much more if they receive the proper investments and incentives. Most of the things that a private manager would do can be done right now by the lotteries themselves in partnership with vendor partners. It's simply a matter of shifting the focus to growth.

As much as there is talk about being focused on bottom-line returns for good causes, the reality is that from a business management point of view, this is a top-line sales-driven business. This is why an Apple comparison is useful. Apple's net profit is about 24% and lottery's net profits are higher. When the margins are as high as they are in lottery, and the various costs relatively low with little room to reduce further, the focus should be on maximizing sales. For example, the average lottery makes a dollar of net profit for four dollars in instant sales. The business plans and vendor contracts of lotteries tend to focus on operating expenses, as though the way to generate more funds is to save money on the operating side of the business. The opposite is true. Lotteries need to invest more money on operations because increased sales are a boon to profits. As a percentage of sales, the operating expenses of lottery are too low. A revenue stream of billions of dollars requires investment. The value of the asset is actually diminished by withholding proper investment.

Lotteries don't necessarily need to have a PMA to invest in the business. But what is needed is to operate like a professional

consumer products company, which means investing in the business. Compare the consumer experience of an Apple customer to a lottery customer. Apple invests not just in the products, but in the whole business with total dedication to creating a memorable consumer experience from the store environment, to packaging to the product's user interface. As profitable as Apple is, the return on investment (ROI) for them is actually somewhat lower than the ROI for lottery. The breakeven on any lottery investment in players clubs, creative promotions or any kind of internet-based marketing is four times sales. This is unbelievable leverage.

Solutions are not readily forthcoming even though lottery executives understand all of this. Government just tends to gravitate towards that which is most familiar. Therefore, government procurement procedures focus on purchasing instead of investing in sales or even overall performance. Instead of looking at the operating budget as the engine that drives sales and profits, lotteries tend to view money saved as money that goes directly to the bottom-line.

It seems like policymakers in U.S. state governments are recognizing this and are increasingly exploring the possibility of pursuing PMA and other investment approaches. State governments are recognizing that the way to generate more bottom-line income in this business is to focus on top-line sales, not cutting investments. Combine this trend with the trend towards interactive extensions of the products and the continued growth in all the traditional lottery products and I think this is one of the most exciting times we've seen in the business. It is a time of genuinely transformative and substantive change. When we look back five years from now, we will be amazed at the way the lottery business has changed.

*Our counterparts in the casino gambling sector have been extremely successful at turning an anonymous player base into a loyal base of repeat customers. How amazing would it be if lottery could manage to convert its incredible base of anonymous customers into a loyal customer base of interactive players?*

**J. Kennedy:** I think that is exactly where we are headed. Players clubs and loyalty programs are the key to making it happen. Players register for 2nd Chance games so we are capturing the consumer information needed to manage the customer relationship. We are building a rich data set of consumer metrics. Players are entering about 30% of non-win-

ning instant tickets entered into our Points for Prizes® programs. And that's across hundreds of thousands of players in Arkansas, Tennessee and Iowa. This will form the foundation for a more comprehensive Customer Relationship Management (CRM) approach to the business. And it's this CRM approach that will enable us to build a fully interactive one-to-one relationship with the consumer.

*You just returned from China. Sales have been growing at a phenomenal rate since Scientific Games launched the China Sports Lottery four years ago. Is this sustainable?*

**J. Kennedy:** The China Sports Lottery is up 48% year-on-year from growth in sports betting and what they call high frequency games like Keno and video lottery terminal games. On the instants side, I would call it a 'sophomore slump.' It is actually a very typical syndrome. The enthusiasm of the new product launch creates momentum that can last a few years. But at some point, that initial blush wears off and you have to shift into the next phase of marketing, which is to focus on the retailers and make sure that they are adequately supported. The many details of execution become more important – things like merchandising and supply chain management. China is such an enormous marketplace that attention to systemic matters relating to merchandising and distribution are critical to success.

*When were instants launched in China?*

**J. Kennedy:** The China Sports Lottery launched their new instants program in 2008 to correspond with the Olympics. We sold our first China Sports Lottery instant game in March 2008. By the end of August 2008, we were selling China Sports Lottery instant games in 31 Chinese provinces. It was remarkable. And so we went from zero to ¥10 billion (\$1.57 billion U.S.) in 10 months that very first year.

*That is remarkable. And the phenomenal growth continued.*

**J. Kennedy:** Absolutely. The China Sports Lottery did nearly ¥20 billion (\$3.1 billion) last year. We started to apply best practices to drive continued improvement. It worked so well at the Sports Lottery that the Welfare Lottery started to mirror us and achieve similarly great success. Since they were following us, the Welfare Lottery remained maybe six to nine months behind in the themes, price points, call-outs, prize structures and distribution—the whole set of

best practices. And so it's really gratifying to actually see that even though we're supplying games to the China Sports Lottery, the China Welfare Lottery mirrored what we were doing and validated some of the core values that Scientific Games has held for years. One of those central values is that there is some fundamental commonality that cuts across all cultures. Markets and gaming cultures may differ, but there are more commonalities to human behavior than there are differences.

*The high early-stage growth rate from a small baseline can't be maintained forever. So are you saying that as the market penetration reaches a certain level, a certain point of equilibrium, the growth rate will level off a little bit and you must shift to a strategy of service, distribution and maintenance of repeat business, as well as push for growth?*

**J. Kennedy:** Yes, this is our experience in the countless start-ups and re-launches we have implemented around the world. Each start-up has the benefit of the knowledge gained from previous start-ups. The Arkansas start-up in 2009 had the benefit of 30-35 lottery start-ups in the U.S. we had done beforehand. The China Sports Lottery start-up had the benefit of our long history of experience all around the world and the data we have acquired from decades of operation in all varieties of marketplaces. The basic trajectory is similar with all start-ups. It begins with a wide consumer adoption of the games surrounded by lots of media coverage and excitement from the public. Of course, we work to maintain the momentum of that initial high level of awareness and support. But we know we have to prepare for transition to the next phase, which is where the real work begins: the focus on execution and the countless details that drive the success of the business. This is when we need to apply the methods and the real science of managing a complex consumer product category. It is when the lottery operator and its commercial partner must work together to control the transition into the middle stage of the product life cycle, where properly managed growth will still be strong. If you look at the best performing lotteries across the world, and certainly now in China, every single one of them has come to this point where they have to drill down into the details of execution, engage the retailers and the players, and tie the products, promotions and merchandising together to create a package that makes sense to the consumer.

The importance of effective management processes kicks in after that initial excitement

of the launch begins to settle. But we have had decades of experience at doing just that and the strong results of this past year reflect this. In the U.S., for instance, sales in the in-stants category increased nearly 10%, from \$32 billion to \$35 billion. And there wasn't one new start-up. It was all accomplished with solid execution at established lotteries.

*What are some of the basic things that you do in switching to the mode of nurturing an established market?*

**J. Kennedy:** It's really important to benchmark. The gaps and opportunities are revealed when you correlate the various indices of performance and then compare those to other marketplaces. The numbers tell the story. Best practices should not be applied as an academic exercise or a method to point out who is doing a good job. Applied correctly, the benchmarks do two things. First, they provide a tool for assessing performance in all the different areas of the business. Interpreted correctly, they show you precisely what can be done

to improve performance and results. There are the big-picture issues like the relationship between payout, price point and sales. We look at the number of games launched and the whole business of managing a portfolio of products for optimal overall results – including same store sales and the methods of the top-performers. We've had discussions about the limitations of the science of data-driven decision making. You are correct in saying that data never gives us the whole picture. Interpretive analyses must convert the data into insights that truly inform the decision-making process. But still, we need to start with the data. And we need to trust the facts more than our subjective interpretive skills. Because where the science becomes really interesting is when you compare the huge volume of data across many jurisdictions around the world. I become more convinced of that over time. Benchmarking for us at Scientific Games involves over 30,000 instant games and innumerable variables that impinge upon

the outcomes. The number of permutations and combinations of the correlative analyses is mind-boggling. We measure performance across all different dimensions and varieties of attributes. Then the analysis of the data informs the whole benchmarking process to tell us how and where there are performance differentials and performance enhancements, and how we can change things to improve results and produce better outcomes.

Instant products are the most intriguing category of games in the sense that the potential for creative to add value is unlimited. This tends to invite people to mix the process of data-driven analysis with their creative impulses. It requires discipline to ensure that decisions are driven by the facts and not by subjective opinions. Scientific Games has an extensive understanding of the science of the instant game category, informed by over \$500 billion in instant game consumer sales. Today, the information needed to make smart decisions is available and we are using it. ♦