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On Asking the Right Questions

Paul Jason, PGRI: *Insofar as Lottery has a far larger market share than any other games-of-chance sector, “convergence” does not seem to be a trend that favors Lottery. Doesn’t Lottery need to fight against this trend, and fight to keep its players from “converging” with other sectors?*

Jim Kennedy: I think your question assumes a zero sum marketplace without meaningful organic growth, therefore, a fight for trading market share. I’d suggest a more actionable question is about growth from doing a better job delivering what consumers want. Our research and experience is clear yes, there is meaningful growth in the lottery business. Consider the range of Gross Gaming Revenue (GGR) in the US. The 2014 annual per capita GGR by state ranges from a high of \$930 to a low of \$64 with an average of \$348. This performance difference clearly indicates a significant opportunity for growth.

The Lottery industry is in an era of unprecedented consumer choice. Convergence in gaming entertainment is happening because consumers have choices. And they vote with their purchases. I think it’s our job as lottery business leaders to sup-

port consumer choice responsibly, or consumers will stop choosing us and choose something else. Instead of thinking about competition and battling for market share with a zero-sum mentality, we all have to focus directly on the consumer and how we as an industry can continue to create value for the consumer. Playing the Lottery is not the same thing as buying a consumable product like an apple or banana. Most people can only eat one apple at a sitting. A person can play an additional \$5 game in one-minute when they can’t eat two apples in one minute. Playing a game is an experience and is much more flexible in its consumption. That’s why we see such amazing year-on-year growth in lottery products, and why the best retailers see Lottery as a growth category. In our experience, by focusing on value creation, the marketplace for Lottery will continue to grow responsibly.

However to generate this new growth, innovation requires a lottery and commercial supplier partnership. For many lotteries, achieving new growth involves a policy change to shift from buying solutions out of the current fixed budgets to a method of investing in evolved solutions with an eye on return from growth. Lotteries have

profit leverage that rewards sales, and we have solutions that can enable this growth.

Content versus distribution: which is the bigger sales-driver?

J. Kennedy: I don’t think you can separate the two. In today’s consumer economy, great content is now distributed on demand and on multiple channels. This is now expected by the consumer. An example is television—we’re currently in the “golden age of content.” Popular TV shows are being created and distributed by Amazon, Netflix, Hulu and high-speed communication companies. They’re available on-demand on tablet computers and smartphones as well as traditional television. If you look at games, a large group of consumers play entertaining games on their mobile devices. For our industry, the great advantage is the retail footprint and the enormous popularity of retail lottery games. Instant games and draw games supported by mobile and interactive promotions add an exciting new dimension to the player experience. Innovating at retail and for distribution, in general, will continue to represent an opportunity to have a direct impact on sales, provided the retailer’s point of view is taken on how

best to integrate into their business. After all, they are the experts at serving their customers in their environments.

Your presentation at the EL Congress in Oslo described three pillars of innovation?

J. Kennedy: Value creation for Lottery stakeholders is the first pillar of innovation. That's about content and creating the best gaming experience for the consumer. It's also about creating value for retailers, who are the face of Lottery to the consumer. If the goal is to have retailers focus on lottery as a product category, their support and dedication to serving the lottery player needs to be earned. The level of retailer engagement is driven by the value created for them. The consumer is the one member of this entire ecosystem who has money to buy lottery games. If we all keep this in mind, the other pieces of the puzzle—like maximizing net profits for good causes—will be much easier to accomplish.

The second pillar is scale. So we know that we must innovate to scale—to the size of our consumer base. Lottery is a \$65 billion consumer product category in the U.S. Globally, it's a \$284 billion category—one of the largest consumer products in the world. Individually, lotteries manage businesses in the tens and hundreds of millions and, in many cases, billions of dollars. This is big business. Our ability to innovate to scale, to innovate across large populations, to leverage best practices globally, and to generate recurring revenue that builds value, is key to long-term success.

The third pillar of innovation is the local, jurisdictional nature of the lottery business. There isn't a customer relationship in any other business quite like the lottery-provider relationship. Government rules, regulations, content, distribution channels, security, responsibility and the general oversight involved require a provider who can innovate with all of these complexities in mind and who can bring decades of knowledge to their innovation and a depth of experience to problem-solving based on the uniqueness of each local jurisdiction.

Overall, I think that perhaps the industry tries to juggle too many objectives, and this may interfere with focusing on those that matter. The mission of Lottery is to maximize net funds transfers to good causes by selling games in a responsible way. This is a business where Lottery has already achieved very respectable operating efficiencies. Margins are over 25 percent, and consumer engagement is broader than virtually any product known. All of this adds up to the fact that if there is a focus on top-line sales, net profits will follow. This is a business where \$4 in sales generates \$1 in net profits for most lotteries. So, increased investment in the business generates more sales. And focusing on sales brings us into direct contact with the consumer. Create value for the consumer and net fund transfers will follow.

So how does the goal of leveraging large-scale comport with the need to adjust for differences between markets and jurisdictions?

J. Kennedy: That brings us right back to the third pillar of innovation. I call it jurisdictional sensitivity. Every lottery has its set of constraints, its rules, and gaming and political cultures. And each Lottery stakeholder, including commercial partners like Scientific Games, must function within those constraints, respect the needs of all stakeholders and serve the needs of each jurisdictional operator. This industry operates in a very jurisdiction-centric way, which means innovation must combine scalability with jurisdictional sensitivity. These are not mutually exclusive objectives. The commonality of consumer behavior in marketplaces all over the world far exceeds the differences. What we learn about consumer behavior and market dynamics in one part of the world informs our overall understanding of the consumer. Every day, we apply this knowledge in markets all around the world. We want to learn from whatever resource, and real-world experience is available to us. We then adapt the learning to the specific needs of each lottery.

The commonality to the way markets behave all around the world is reflected in the commonality to the products sold by lotteries all around the world. But Scientific Games also needs to embrace the specific objectives, work within the specific constraints, and meet the unique needs, of each lottery operator.

J. Kennedy: That's exactly right. The Lottery industry requires commercial partners with global reach and world-class capabilities. The R & D, productive capacity, insights and game development resources, delivery and service infrastructure, etc. need to support scalability commensurate with a \$284 billion industry. Lottery also needs its commercial partners to focus these resources on the clear objective of driving its jurisdiction-specific business agenda. So we need to do both: create world-class content and adapt all of our solutions to the jurisdiction-specific needs of our Lottery customers. To do this, we need an organization with global reach, with game development infrastructure that integrates input from all game categories, and with capacity in production, sales, and marketing to scale up quickly. That, in a nutshell, is the rationale for Scientific Games' acquisition of Bally Technologies and WMS Industries. These recent acquisitions are two of over a dozen acquisitions we've done in the last decade. This constant infusion of new, creative energy married with the security and scale of Scientific Games give our customers the best of scale, innovation and security available today.

Why does anything need to scale up "quickly?" Isn't government gaming an industry where everything happens in cautious, deliberate fashion?

J. Kennedy: Not in the game categories that Scientific Games has always excelled. Instant games are a super fast-moving category with product life-cycles that are constantly refreshed. The consumer expects this in every game category now. Scientific Games provides our customers more than 3,500 instant games a year. Over the last ten years, that's 35,000 in-

dividual customized, localized games. We produce more unique core lottery content than any other supplier in the world by a wide range. Our culture of scale and pace has produced very successful and measurable results. The instant products business has driven the growth in the U.S. and around the world. Instant games are the fastest growing lottery category measured by dollar contribution. And we stretch our innovation to encompass not just the games, but the whole gaming experience: the ecosystem of the lottery system, just-in-time inventory from design and manufacturing, and custom retail delivery. Then, second-chance draws and licensed products have extended the player experience and tapped into the demand to affiliate with pop culture. And our player loyalty programs have created a relationship-based platform to engage consumers further.

Meeting the demand for continuous and innovative content development, and creating fresh ways to enhance the overall player experience is in our DNA. It's what we have always done, and it's what positions our customers for success in a world where speed to market and short-product life cycles are critical to building a successful and sustainable business.

It seems that there will never be a killer app as far as games go. First, Angry Birds was the rage and then Candy Crush. iPoker was thought to have enduring appeal, and even it is showing signs of declining popularity.

J. Kennedy: We manage product categories that are an integrated collection of individual games. To build value over time, we help our customers manage their entire portfolio, the entire player experience. Content creation is not just about creating the next killer app. I think this painful lesson has come to many in the interactive space; the game curve is like death and taxes. We've known this for decades. Consumers fall in and out of love with a specific game, but they stay with the category if you do it right. Content

creation is the ability to attract and entertain consumers in an environment that is constantly novel, constantly reassuring, and constantly adjusting and evolving with that consumer. It is a delicate balance, and that's really where our core competency lies.

I love that we are called Scientific Games. It's a perfect description of success in this business. We nurture the yin-yang marriage of science and art. The science is focused on truly understanding player behavior, applying the scientific method of proposing a data-driven thesis, testing it, adjusting and re-testing. Playing games is an ethereal experience, and it involves underlying behavioral dynamics that can be difficult to measure. There is an art to combining measurable data with insight into what lies behind the data. And even the art of interpreting the data is informed by decades of real-world experience that further informs the whole process.

We have evolved our customer segmentation over the last two years by focusing on consumer motivation. The sheer numbers of consumers who participated in the primary research stage through the segmentation process give us a sound basis for analyzing and classifying motivational drivers. For example, there is much talk about Millennials, the 24- to 35-year-old demographic that which is so key to positioning the Lottery business for long-term success. Our segmentation studies are yielding tremendous insights into how the buyer motives of this group vary greatly. Understanding that this is the least homogeneous consumer group opens up a wealth of opportunity for us to create value by focusing product development and promotions that appeal more directly to the diversity of the buyer motives of the millennial.

Integrating our primary research into our rich source of secondary sales and attribute research that use over a million weeks of data provides our customers the critical information they need to make informed decisions. I think the results speak for themselves. Our lottery customers who

have chosen Scientific Games as their primary instant game provider have the best-selling instant game categories in the industry.

One last question on what I see as the problem that convergence creates for Lottery: Insofar as there is cross-over between the Lottery player and casino gambling, how can Lottery not be the loser in that battle for player-ship?

J. Kennedy: Consumers don't see it this way, consumers enjoy Lottery AND casino games. Great games and great access to great games are what the consumer demands and will choose. Let's look at a state like Arizona where there is a large number of tribal gaming casinos and a growing lottery. In 2014, the Arizona Lottery generated approximately \$724 million in revenue, which amounts to gross gaming revenue (GGR), or sales minus prize payouts, of \$268 million, and transfers of \$176 million, or 65 percent of GGR, to public education, health and human services and other good causes. Now look at the Native American casinos in Arizona that produce around \$1.8 billion GGR. So, in total, Arizona consumers chose gaming entertainment of over \$2.5 billion dollars in GGR last year. These facts and our research suggest that consumers have already converged.

Asking about competition between Lottery marketplaces and casino gaming marketplaces is the wrong question to ask because it simply does not produce a growth solution. These are the same consumers visiting different retail distribution locations. Instead, we want to recognize that 65 percent of any increase in Lottery GGR generated is returned to beneficiaries in the State of Arizona! The question to ask is: How do we increase Lottery sales and GGR by investing in the consumer? We do this by creating value for the consumer who is choosing gaming entertainment. ■