



Doubling Down: Value Transformation in Lottery

Martin Kon, Partner (above left)

Tim Natusch, Partner (above right)

When officials in Illinois and Indiana took an objective look at their lottery assets, they believed that they could do better – a lot better – by working more closely with private-sector operators. Only one year after signing a private management agreement with the Northstar Lottery group, Illinois' lottery leapfrogged peers to become the third fastest growing lottery in the country, in a period when many lotteries also enjoyed strong growth. In its first year the agreement has generated an additional \$100m in Net Income. Indiana, through its new integrated services agreement with GTech, expects to move from the bottom third of lotteries to the top third on key performance measures over the next five years, and is ultimately expecting to generate an additional \$100m to the bottom line every year. Both states have contractual commitments from their private sector service providers to significantly increase lottery profits to their State's treasuries.

As governments continue to struggle financially and search for additional sources of revenue, lottery directors will be challenged by their state's financial managers to ensure they are performing at the very highest levels.

The states of Illinois and Indiana were both advised on growth opportunities and on the process of selecting commercial partners by the global consulting firm Oliver Wyman. In the days following Indiana's announcement of a 15-year operating services agreement with GTech – which is projected to increase returns to the State by \$2.1B.

Paul Jason sat down with the Oliver Wyman Partners involved in both transactions, asking Martin Kon and Tim Matusch to reflect on what can be learned from the Illinois and Indiana experiences and how they see this nascent transactional environment evolving in the context of Oliver Wyman's extensive work in the global gaming & lottery industry, and their own personal experience across North America and Europe.

Paul Jason, Public Gaming: *What should we take away from the experiences of Illinois and Indiana?*

Martin Kon: Two things: firstly, that very significant amounts of value can be added if status quo thinking is challenged; secondly, that these transactions can be completed successfully in relatively short time-frames (under 6 months) if there is a well-defined schedule of decisions and it is adhered to.

Our mandate in both instances was clear: to determine the full value potential of the lottery franchise and then to structure the best possible way to realize this value...within the specific context of each jurisdiction.

The successes in Illinois and Indiana are largely down to the fact that our clients were open to fundamentally transforming their business in order to maximize returns to the state. They recognized that doing better than last year, or being on par with a peer set, wasn't good enough. Instead, they wanted to step back and really understand what was possible. They needed to know what could be achieved given their current state of operations, the market context, as well as the political and policy objectives of government bodies that ultimately own and control the assets.

What is it about the current state of lottery operations that requires a transformational approach?

Tim Matusch: The real upside in these situations doesn't come from incremental improvements; it comes from a complete re-design of the business. And the fact is that there has been remarkably little innovation in product delivery, service delivery or the basic operating model in this sector in the past 10 to 20 years.

However, state-run lotteries are generally considered to be very successful enterprises – they make significant contributions to state funds

and as long as the money keeps on coming in, there seems little reason to question their performance. They are, after all, already the largest non-tax revenue source for many jurisdictions. But what we find is that year-on-year, or peer-to-peer comparisons are not the best way to answer this question, because you are not pushing the thinking and freeing up the constraints which could dramatically improve Lottery performance. Once you have a real sense of how much revenue the State is missing out on, that's when the meaningful policy discussions can happen.

Generally speaking, it's not that state employees are ineffective managers. But the parameters under which they operate often limit their ability to drive step-changes in performance. For example, it can be difficult to establish effective incentive-based compensation programs; it can be difficult to make significant long-term investments in technology or R&D which are key enablers of future value; it can be difficult to make return on investment-based marketing spend decisions. And beyond that, bureaucratic processes often prevent officials from responding rapidly to changing market conditions in the way that today's marketplace demands.

In many cases, the best way to increase value for the state is to approximate a private sector environment, as far as possible within the legislative framework and public policy intentions, to grow the business.

What trends are emerging as more state lotteries consider their options?

M. Kon: One of the most powerful components in both of these transactions has been the unerring focus on profit growth. Too many vendor contracts in the Lottery & Gaming sector are based around top-line performance, which does not necessarily flow through to the bottom-line.

Beyond that, probably the most important trend is the growing appreciation that every situation is critically different in terms of objectives, priorities, and sensitivities. There is no one ideal transaction structure, incentive scheme, or selection process. That being said, virtually all jurisdictions want to realize greater value from their lottery and/or gaming assets.

The question all lotteries, even growing ones, should be asking themselves is, "Are we achieving our full value potential?" As a result of our extensive work in the international lottery sector, we have built a robust Value Identification Platform that can measure performance gaps across all relevant performance levers. The reasons for under-performance are not always the same. But once they have been identified, quantified, and properly understood, the question becomes how to close the gaps under current legislation, as well as under future legislation scenarios reflecting potential changes to public policy, such as new game types, expansion of digital options, etc.

Is an agreement with a private operator always required to close these gaps?

M. Kon: No, not at all. The only requirements are a commitment to transforming the business and an appreciation that such transformation can only be achieved by challenging the status quo. And that takes dedication and investment.

In the cases of Illinois and Indiana, both believed that deeper engagement with the private sector was the fastest and most efficient way to achieve a step-change in performance.

However, Oliver Wyman has also supported other state-run gaming and lottery operators to achieve substantial breakthroughs without engaging private operators. For example, Française des Jeux (FdJ), the national lottery in France and second largest in the world, chose to close the performance gaps that were identified by launching an internal Value Transformation program to upgrade key capabilities and operating standards. Three years later, revenues have increased

Value Transformation in the Public Sector

Oliver Wyman's Lottery & Gaming Practice includes partners and consultants who have deep experience with operators across North America and Europe. The Practice's unique approach balances maximum value creation with sensitivity to public policy considerations. Two former senior government gaming officials, Rob Moore and Jodie Winnett, are Oliver Wyman affiliates, and integral parts of the expert teams working in this sector.



Jodie Winnett is a former Associate Director, Illinois Department of Revenue and oversaw the Illinois Lottery from 2007 to 2011, including the transition to private management.

"Being the first State to interpret the 2008 DOJ opinion in the context of setting up a more commercial structure for our lottery, we worked with Oliver Wyman and our legal team to define an incentive structure that would keep the private manager focused on ever-improving performance and to introduce a disciplined bidding mechanism – all within the parameters of the federal opinion and our own authorizing statute."



Rob Moore was the Senior Vice President of Marketing, Communications, Stakeholder Relations & Strategy at the Ontario Lottery & Gaming Corporation (OLG) from 2008 to 2011. On behalf of the Government of Ontario he led the 'OLG Strategic Business Review' – a process that evaluated current public lottery and gaming operations and assets, ultimately recommending to the Government OLG's transformational Modernization Plan (www.modernolg.ca). Under this Plan, which is currently being implemented, OLG will contribute, within 5 years, an additional \$1.3 billion a year to the treasury and \$3 billion in private-sector capital investment in Ontario, as well as 2,300 net new jobs in the lottery and gaming industry.

"When you can shift the assessment of the opportunity from incremental improvement to transformational – and you get the complicated balance of market forces and political circumstances right – the value creation potential in these environments is among the more exciting you will find in any industry anywhere in the world right now."

by €2.2b (+24%), even though this period also saw the opening of the digital gaming market to competition.

Market dynamics, operating dynamics, and political dynamics will vary by jurisdiction – the blend of these and other factors will determine the best course of action.

Can you provide examples of market or operational dynamics?

T. Matusch: Sure. These are essentially entertainment companies, competing for consumers' time and discretionary spend, and we approach them in a similar way to other businesses in the entertainment space. Of course, in this sector, there are unique considerations around responsible gaming and regulatory oversight that require specific expertise to reflect properly. But when you look through a 'business' lens, you find three consistent market factors: the state of the existing technology and related contractual obligations; channel penetration; and new product opportunities.

Firstly, technology remains a critical component of any lottery business, and existing technology contracts are a critical consideration in a private operator selection process. The established lottery technology platform providers are very active in these processes, as they seek to leverage their experience and expand their service offering; while any increased interest and competition will ultimately benefit the industry, there's no denying that it adds a layer of complexity when the providers of the platform are also bidders to become the private operator. However, it is essential to keep in mind that the ultimate objective is simply to create the most attractive transaction structure and bidding environment for the state, not for one category of bidders or another.

Given the amount of investment and risk involved in these agreements, private operators are likely to want to oversee at least one, if not two, technology platform renewals over the term of the contract. So, our advice to state lotteries is to really understand the extent of their flexibility within their existing technology contracts. Ideally, lotteries should begin exploring options when they have 2 to 4 years remaining on a system contract. That gives a time for a year-long selection process and an orderly transition to a new platform should that be required. It also provides the opportunity for a completely new system and approach to be considered by the new private manager, if they feel that would enable improved bottom-line performance that they would commit to delivering.

Secondly, every state-run lottery operation has developed bricks-and-mortar retail networks to sell their products, but most of these networks have not kept pace with emerging technologies and changing customer behavior. The degree to which a state is prepared to modernize its recruiting and licensing processes and oversee the introduction of lottery products into new channels such as online & mobile, self-serve environments, multilane sales in grocery or big-box retail environments, bars and restaurants, will have a huge impact on the value that can be achieved from an agreement with a private manager.

Thirdly, for the most part, the basic mechanics of lottery games have not changed in decades – draw and scratch games dominate the market. The appeal of the current product portfolio to younger demographics is limited. So, the ability to innovate and bring completely new gaming experiences to market, especially harnessing the digital innovation we already see in virtually every other media & entertainment sector, is a key consideration.

And how do different political and policy objectives shape the direction of a business transformation effort?

T. Matusch: To achieve success in any public-sector transformation process, it is essential to focus on the "art of the possible." The direction and parameters are being set by the elected officials who bear ultimate responsibility for the assets in question, and numerous overlapping legislative, political, and legal considerations will have an impact on the path each jurisdiction chooses to pursue. At a minimum, issues such as the amount of time remaining in the mandate of the state's chief executive, current public opinion about lottery and gaming, the appetite for new forms of games and channels, and existing legislation must all be carefully weighed.

How do these legislation or legal circumstances affect the ultimate process on which you provide advice?

M. Kon: The most important consideration is political will. As we have mentioned, state-run gaming and lottery operations are vital sources of public revenue. They are also usually managed by a highly visible agency or commission, and undertaking a transformation program will attract considerable public attention and scrutiny. Without the commitment of the required elected officials to take that challenge on, proceeding with any type of significant transformation program would be impossible.

Presuming the political will is there, the varying legal opinions and interpretations of legislation that provide the legitimacy for all legal lottery and gaming have to be factored into the process. For example, in the US, the boundaries revolve around the 2008 U.S. Department of Justice opinion on lottery ownership, while in Canada, that means the interpretation of the Criminal Code. In both countries, there is an acceptance that the state must continue to play an important role in the provision of lottery and gaming. However, agreement on exactly how this role can be played is far from unanimous.

We spend a lot of time with lawyers during our work with lottery & gaming operators, because the prospect of a legal challenge must be understood and evaluated within the timing and scope of the process. Billions of dollars of value, compensation structures, bidding models, as well as numerous other considerations, hinge on the interpretation of "de minimis share of the equity interest" in the US DOJ Opinion and of "conduct and manage" in the Criminal Code of Canada.

Political and legal considerations play a major part in our advice to clients and in the crafting of a deal's structure. Many pundits may claim to have a better approach than the one any given State might decide on, but they perhaps don't have an appreciation of these political and legal parameters, which add complexity to how a state can maximize its interests and ultimately shape the opportunities and processes that are possible.

Presuming you have an alignment of the political and operational sides to seek a private operator, what are the success factors in designing an effective bid process?

T. Matusch: Every process will have its own unique elements based on what we just discussed, but there are a few simple but critical success factors: 1) understanding the value at stake and what it will take to realize that value; 2) creating a process which attracts multiple high-quality and motivated bidders; 3) iterating key deal elements with all relevant stakeholders, including the bidding community, such that a reasonable contract is in place before the selection process is complete; 4) developing a selection process that is objective and oriented on bottom-line performance improvement.

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proach to growing the industry. In fact, for all the talk about social gaming, my focus is on retail as being the best venue for social gaming. And the way we want to integrate mobile and i-Pads is to enable our players to create more social interaction, between us and them but also for players to communicate and share with each other.

What can the industry associations like the WLA and EL do to encourage cooperation between lotteries to build a powerful brand that is recognized by governments as the leader in areas like sustainability, responsible gaming, and security standards?

F. Paes Afonso: Communicate, communicate, communicate. That is what our adversaries in the remote i-gambling sector do. They communicate with the press and with the government. We are losing the communications battle. And that is incredible. In terms of revenues, reputation, longevity, and public awareness, lotteries are the elephant of the industry. These remote operators are the mouse that roars and we are like the elephant who is afraid of the mouse.

The WLA, EL and CIBELAE can be the instrument for change and the vehicle to communicate our message to the press, to

governments, and to international governing bodies like the European Union Commission. For our associations to be effective, they need the active support of all the lotteries in the world. They need to meet more to work out the strategies and action plans that will have an impact on public opinion and governmental decisions. I am convinced that we can succeed at getting this message across and persuading the shapers of public policy to support our plans for sustainable growth of the industry. But it will require communication and cooperation between lotteries. That should not be as hard as we sometimes seem to make it. Look at the commercial community of internet gaming operators. These people compete with each other. They are enemies in the market-place and are often even suing each other in court. But when it comes to their political agenda, they all see that they will accomplish more by cooperating and speaking with one voice. Lotteries do not compete with each other and in fact share almost all the same values and operate with similar business models. And yet we do not collaborate as well as the commercial i-gaming operators when it comes to public relations and communicating with the shapers of public policy.

Back in the years just prior to leaving the lottery in 2005, you were instrumental in implementing EuroMillions and also in communicating with the European Parliament about the importance of protecting the rights of member states to determine their own regulatory and taxation policy. Now you have just been appointed to the executive committee of the European Lottery association.

F. Paes Afonso: Of course, there are many others who have worked hard to lead the associations throughout the years, and to great effect. Look at all that has been accomplished, especially by the European Lottery Association. The community of remote i-gaming operators was on the cusp of overturning the fundamental regulatory model in Europe and that was prevented. But there is much more that needs to be done. The debates continue. That is why we must continue to press our case with the European Commission. We need to address their concerns, propose solutions to their questions, help them resolve the trade-off between the principles of the Common Market and the need for member states to control regulation and taxation of gambling. And we need to take this message to the public and to our players as well. ♦

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Now, these are public competitive processes, and there is no shortage of opinion on how best to structure them. Some parties have called for up-front payments; others have called for a range of different incentive structures. But let's be clear, these transactions have to reflect what's possible under the law, and the interpretation is not always black and white. Some lawyers advise that upfront payments of any significance from a private operator would be deemed illegal, others may take a different perspective.

Importantly, these are neither traditional service procurements, nor privatizations that concession the use of state assets for a period of time; these are quite unique arrangements. We appreciate that there are participants that are more comfortable at one end of this continuum or the other, but the competitions will likely be between entities with quite different positions in the industry, so you can never select a single-process mechanism that will be fully embraced by all participants. Our goal is not to create the perfect process for all bidders, it's to create the process that delivers maximum value for the state. There is not a cookie-cutter approach; we are all actively participating in and watching the evolution of these processes, and the unique circumstances of each jurisdiction and the varied backgrounds of the proponents in the private sector necessitate an evolutionary approach. Each state will learn from the experiences of those that preceded it.

In our experience over the past few years - advising on most of the recent processes that have come to fruition - there is an increasing level of trust between the government operators and the private sector bidding entities. We would not be so bold as to say there is absolute alignment yet. However, there is a growing appreciation in both the public and private sector of the intrinsic benefits of transferred risk, stability, investment, best-in-breed operations, and continued state oversight. The pace and number of these processes will likely increase, and over the next few years, we will be looking at a very different global lottery industry.

Any final thoughts before we wrap up?

M. Kon: We would encourage stake-holders to really challenge their thinking in terms of what is possible. We firmly believe that there is significant upside in most state-run Lottery businesses, and carefully identifying performance improvement opportunities, through our Value Identification Platform for example, is a crucial first step. We have experienced firsthand the extraordinary incremental value that can be created, through both internal and external transformations, amounting to hundreds of millions or even billions of dollars. And that should be of interest to any Treasurer, Finance Minister or Director of Revenue! ♦