Self-Disruption as Survival Strategy

Introduction to the panel discussion that follows on page 22:

Tom **Delacenserie**

President & Chief Executive Officer,
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A Missed Opportunity: Following WWII in 1948, the Wolfsburg Volkswagen Factory desperately needed a capital infusion. The oldest grandson of Henry Ford could have bought Volkswagen for a song. Ford passed on the opportunity and nobody wanted to buy Volkswagen, so the factory was given to the plant manager. Sales of automobiles soared after WWII. In 1980 Ford globally was still twice as big as VW. In 2000 Volkswagen sales were nearly even with Ford. By 2017 the Volkswagen group had become *twice as large* as Ford. And today Ford is basically struggling to stay relevant in the global market. Ford had been disrupted.

How did VW not only disrupt Ford but the entire automobile industry once dominated by the big three in Detroit? For one thing, Detroit focused on strategies that maximized short term gains and shareholder value. The Germans, Japanese, and Koreans focused on long term gains, building a business model based on sustainable and steady growth. That meant giving less regard to maximizing margins and cutting costs, and more attention to maximizing new features, benefits, and value for the consumer. Volkswagen also aggressively pursued electronic technology and a very careful and disciplined product release strategy in China, a market that Ford was not even in.

Of course, Ford is not the only company that's ever been disrupted. Eastman Kodak dominated the camera and film business as late as the 1990s. The most interesting aspect of this story is that Eastman Kodak had the proprietary technology necessary to dominate the digital business. But senior management at Eastman Kodak felt that digital would cannibalize the profitable film business. Failure to self-disrupt cost shareholders everything. On the opposite side of the spectrum you've got the disrupters - companies like Apple, Amazon, Uber, Lyft, Airbnb creating new business models that disrupt the established way of doing things and in the process reshape entire product categories and even industrial sectors. So which will we be – the disrupter or the disrupted?

Retailers are choosing to self-disrupt their business model by improving the shopping experience for the benefit of the consumer and for the purpose of building a sustainable business model. It starts with the physical store. Let's start with the basic thesis that the physical in-store shopping experience is going to survive and even thrive. But it is going to evolve. And many store operators are failing because they are not moving quickly enough to transition with the modern consumer.

Retail Self-disruption Exhibit A: It is estimated that more than 8,500 stores in the United States closed in 2017. At the same time, online-first brands are opening everything from pop-up store showrooms to full blown physical stores. Amazon alone plans to open 2,000 Amazon fresh grocery stores in the next ten years. Amazon is also the one who is revolutionizing the entire in-store shopping experience. Amazon Go is just its first salvo. Result, consumers have unique and improved physical store/shopping choices. Retail is not dying. For some, like Amazon, it's thriving. It's just being disrupted.

Retailers are investing in technology and modernization. Gartner projects retailers will spend over $206 billion on technology in 2019. So what are they buying? 23% of retailers currently have some type of AI capability and 30% more will add it over the next three years. 19% currently have IoT (Internet of Things) with 36% more adding the function over the next three years. Their investments in technology seems to be paying off. In 2018 a global insight survey showed that **the percentage of weekly brick and mortar shoppers actually rose from 40% in 2015 to 44% in 2018.**

We need to watch the behavior of and listen to the consumer to understand how and where to channel the investment in technology. A recent study from Oracle NetSuite surveyed 1200 consumers and 400 retail executives in the U.S., the U.K., and Australia. The disconnect between the executives and the consumer was startling. When asked if the retail environment was more inviting over the past five years 73% of executives answered "yes" compared with only 45% of consumers. 19% of consumers actually said it was less inviting. When asked if in store chat box met consumer needs, 79% of executives answered yes compared with 34% of consumers. When asked if engaging with customers on social media helped strengthen their relationship, 98% of executives answered "yes". Only 12% of consumers felt that it had any significant impact on how they feel or think about the brand. That's a disturbing disconnect.

Tom Stanek of IGT explained how the shopping experience of the future will have more options, a wider variety of tradestyles, and will not be a one-size-fits-all. Retailers are now in a position of trying to deliver too wide a variety of options. For example, it would seem that getting the customer to buy online and pick up at the store (BOPUS) would be a good strategy to keep land-based retailers relevant. Well, it does keep retailers in the loop. Unfortunately, the cost of picking the orders causes retailers to lose money. The more they sell, the more they lose. For now, retailers are doing everything they can to preserve their connection with the consumer. Presumably, they will find an equilibrium that does not require them to offer options that cause them to lose money. The total grocery market in the U.S. today is $800 billion. Online accounts for just 3% of that figure, which is $24 billion. But it's growing and retail does want to stay highly focused on providing a value proposition that will keep its sector in growth mode.

The funds we have available to us to invest in technology are limited. Some lessons we can take from these and other success stories:

- Land-based retail is being disrupted but will continue to dominate the space that connects merchant and consumer for many years to come
- Disruption of Retail will result in many failures of companies, chain stores, and suppliers who fail to adapt.
- Disruption represents an opportunity for those who do adapt
- Adaption isn't a state of mind – **it requires investment**

Let's look at an example in our industry. When you launch a scratch game, one of two things must happen. One, the retailer gets credit before the launch so they can remove an existing game from the POS and insert the new game which will sell way more than the old game. Or, they leave the old game in until it sells out before displaying the new game. Either way we lose. I asked IGT if we could incent the retailer to do things in a way that drove sales performance. Our solution: We told the retailers which three games they could remove and gave them a 2-day window to remove those three games - you can't remove any but these three specified games and you have two days after the launch to do it. If you try to take out any other games it won't work, and if you try to go beyond that 2-day window, it won't work. Our sales reps do need to confirm that what retailers did complies with these conditions. But the result is that the retailer has a crystal clear choice: Refresh your POS with the new games according to our rules, thereby receiving credit for the purchase of new games, attracting more foot traffic because players know you have the best games ready to play, and increase the sale of lottery games – or fail to do that and don't receive credit and suffer lower sales because you have old product on the shelves.

Disruption is happening right now whether we know it's happening or not, whether we want it to happen or not, or whether we accept it or not. We can choose to be among those who act rather than react. Lottery does not even want to be the pioneer and, thankfully, we don't have to be the trail-blazing pioneering innovator who must learn from mistakes and multiple iterations. Others have done that and will continue to do that for us, enabling us to assess what works and what doesn't. As fast followers, we should be able to see opportunities to adapt these technological tools and modernization initiatives to improve on what's been done before and optimize the ROI on investing in our own industry. But we do have to apply the vision and have the fortitude and integrity to be fast-followers. We can clearly see many things that must be done and we need to find the ways to persuade our stakeholders to support the investment to make them happen now.

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Self-Disruption as Survival Strategy

Following is an edited version of the panel discussion held at PGRI SMART-Tech on February 28 in Fort Lauderdale, FL. You can view a video of the complete presentation at www.PGRItalks.com.

Panel Discussion Retail:

Disrupt or be disrupted. The success strategies for Lottery in the transformation of the retail shopping experience

Moderator: Tom Delacenserie, President & Chief Executive Officer, Kentucky Lottery Corp.

Gary Grief, Executive Director, Texas Lottery

Tom Stanek, Head of Global Retail Sales & Marketing, IGT

Drew Svitko, Executive Director, Pennsylvania Lottery

T. Delacenserie: What kinds of self-disruption at Retail are you seeing in your markets, and how is it impacting Lottery?

D. Svitko: We're seeing a lot of focus on food and beverage. These are high-margin categories but it's more than that. C-stores and grocery stores also want to provide an environment that encourages people to stay, to increase in-store "dwell-time". I think retailers are also exploring ways to provide entertainment value that will change the way consumers think about the shopping experience, to think of it as an enjoyable experience instead of the singular objective of going into the store to buy something and complete the task ASAP.

This would seem to represent an opportunity for Lottery products that deliver a "stay-and-play" experience like monitor games, keno and our sports games. And for retailers who want to promote "stay-and-play" but don't want to incur additional time burden on their store staff, lottery vending machines are delivering a more entertaining player experience than ever. So, the value delivered by vending machines isn't just about moving the player from clerk-assisted to self-serve, it's also about increasing in-store dwell-time.

G. Grief: Thank you for these great examples, Drew and Tom. In Texas, the H-E-B Grocery is very successful, represents a massive retail footprint in our marketplace, and is a huge seller of lottery products. There are a couple of things happening at H-E-B that causes me to be concerned that our methods are not aligning with their modernization initiatives. One, the lottery terminal and the place where people go to cash their prizes is located in the customer service area. H-E-B is phasing out this customer service area in some store locations and so we must convince the retailer to provide a POS location that will appeal to lottery players and keep us visible and accessible to the players. In addition, H-E-B is jumping on the whole craft-beer trend which bumps up against our state statute prohibiting lottery from being played where alcohol is consumed. We're finding compromise solutions, but some of these retailing trends are not working in our favor.

Tom has often talked about what I think is a big part of the solution going forward. And that is we need to make it easier for retailers, especially the big chain stores, to do business with us. If retailers think of lottery as an outlier product that creates laborious accounting and inventory management issues, they won't much care if changes they make have the collateral effect of damaging lottery.

T. Delacenserie: Retail is here to stay, but disruption will rule the day. It wasn't too long ago that we were thinking that retailers should put our POS on the counter top and clerks should upsell lottery products. Now we have to prepare for a time when there won't even be counter-tops or clerks. What can we do to get out in front, to be the self-disrupter instead of the disrupted?

T. Stanek: IGT is supporting the New York Lottery's partnership with OTG Hospitality & Food Management Group in LaGuardia Airport to sell e-instant tickets. OTG is basically transforming the entire airport dining experience with better food and modern tablet-based ordering system. We integrated with OTG's back-end system and are hoping to forge a new channel of distribution which puts us in front of a different type of consumer. To your point, Tom, this initiative also disrupts our business as well because we have to integrate with the retailers' own transaction-processing devices instead of just routing through our own dedicated terminals. But for all the reasons that everyone is pointing out, there really is no question as to whether we should self-disrupt like this. Whatever downsides or challenges will need to be faced regardless of what we want or do, being proactive and self-disrupting is creating some exciting upside possibilities.

T. Delacenserie: How do we work as an industry to close that gap between what we are able to do and what the consumer and retailer expects us to do?

G. Grief: I think that's going to take a combination of vision and collaboration on the part of lotteries, our vendors, and our retailers. It will also take courage for all of us and all lottery stakeholders to push for what is right, for what is needed to support a sustainable model that continues to serve our beneficiaries for generations to come.

I take a very positive view of the disrupters in our industry. The Jackpockets, the Link-3s, the InComms, Black Hawk, Abacus Lottery Everywhere – these disrupters are driving us to stretch and adapt to incorporate new technologies and products into our businesses. In-lane sales do not only mean more POS's. It puts lottery into new retail categories and channels of distribution. As we demonstrate our ability to work with major corporate accounts on their terms, meeting a higher standard of expectations for accounting, reporting, and business process in general, that should open even more doors to us. We may start with Powerball and Mega Millions. But then getting the scratch products into these channels will be the next big step.

I will add that I am preparing my stakeholders to expect early-stage results for in-lane to fall below projections. As with any innovation, there is often a gap between

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The RG tools integrated into our Mobile app are all voluntary. But insofar as players choose to use these tools, they will help them to better manage their play. Legislators recognize the public service that our proactive approach towards RG represents, and it gives them greater confidence that they can support the role of Lottery in society.

Our responsible gaming program is foundational to our ambitious growth plans. The biggest impact will come from our ability to convert data into useful and applied business intelligence. That will be key to helping us help our players. We will move from anonymous play to known play, from unregistered transactions at retail to a digital first/customer first experience.

Data-driven insights will give us an incredibly robust view of our players and enable us to help them manage and make informed choices about their play – allowing us to grow our revenues responsibly.

Third-party certification a must

I recommend getting certified both through NASPAL and the World Lottery Association. It is a lot of work, but the brain-trust that informs the whole WLA RG certification process is invaluable. Third-party auditors confirm that you are in fact doing all the things that you say you're doing in your program.

The certification demonstrates to your stakeholders that you really are walking the talk – and in turn builds trust. As I sit down with legislators and consumer advocates and other outside groups concerned about expanded gambling, I can show them that we're are dedicated to implementing a sustainable growth plan that minimizes social costs. Since I last spoke at a PGRI conference in New York last year, I'm proud to share that the Oregon Lottery has received Level 4 Certification from the World Lottery Association.

So you see, RG is not simply a feel good activity. It's a lens we apply to all aspects of our business. It's a responsibility of all Lottery employees and retailers. It's about keeping entertainment entertaining and allows us to deliver funding for programs Oregonians care about, now and in the future.

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the acceptance by early-adopters and getting embraced by the mass-market. But that is to be expected. Let's stay focused on pressing forward with these initiatives that are so vital to the future of our industry.

One other initiative that should remain top-of-mind is the universal API for everyone. I believe that solving the API issue is key to modernizing our back-office operations to integrate effectively with the modern retailer.

T. Delacenserie: Thank you, Gary. We need to anticipate the way initiatives inevitably evolve and stay on course and committed to building the platforms that will form the basis for even more ambitious initiatives. And I second your call-out of appreciation to all our vendors who challenge us to think different, think bigger and outside the box to apply new solutions. Tom, what are your thoughts about closing that gap between what we offer and what consumers expect?

T. Stanek: One observation is that, unfortunately, the gap between consumer expectations and the reality of what we as an industry can deliver narrowing, it's getting wider. Gary, you referred to the time lapse between early-adopters and broad mass-market acceptance of a new product or solution. That time-lapse has been our friend, allowing us the wiggle room to catch up to the market before it was too late. Well, the next generation of players are being referred to as digital natives because they grew up with digital technology. Their willingness to incur the learning curve and leap right into the new-and-improved version or even the radical innovation will reduce that time-lapse between launch and mass-market acceptance. We can longer have a leisurely wait-and-see approach. More specifically, we better be on our toes, ready to jump in as soon as the early returns indicate that a new idea, like in-lane sales and cashless options, is trending up. If we don't move more quickly to meet the needs of the consumer, the gap that separates consumer expectations from the reality of what we are delivering will get wider and wider.

T. Delacenserie: Modernization and upgrading technology costs money. How do we work together to manage this risk reward equation and grow the business while ensuring that there's still a profitable bottom line for everybody? Drew?

D. Svitko: I think it comes down to smart innovation - understanding what our goals are, prioritizing the opportunities, applying a realistic feasibility calculus as well as thorough risk assessment analysis. We start with the vision we have for our business, what our role in the retail world is right now and how we might evolve that into a more productive and impactful role going forward. As my colleagues on the panel point out, that means paying attention to best practices as applied outside of the lottery industry as well as consumer trends as they manifest across all commercial segments.

Each one of us – Lottery, Vendor, and Retailer – needs to have a clear roadmap for how to navigate these issues. We can't all be expert at everything. We need to stretch to understand the issues from the other points of view but we also need to appreciate that there is much we do not understand about others' POVs. But with a clear understanding of our own business, with a precise measure of the costs and benefits of different courses of action, with an abiding respect for the opinions of our vendor and retail partners, and with a firm conviction that we can work together to forge mutually agreeable pathways forward, we will get there. I don't think there is anything that surprising about that short list of principles to effective collaboration.

In the case of Pennsylvania, we established early on that all parties to collaboration must be willing to assume some measure of risk. For instance, we committed to buying a new machine before it was even out of development. Our vendor partner needed the commitment, we knew the consumer demand was there, and we were confident that the product would meet the needs of the market-place. Happily, I got a text just yesterday from our team at the Walmart supplier forum in Bentonville that this new machine was recognized by Walmart as its "Supplier Product of the Year." Of course we are pleased. But I would also point out that this recognition really speaks to how important the lottery industry is to Walmart. Further to that, the Pennsylvania Lottery was a runner-up for Walmart Partner of the Year, finishing behind FedEx.

T. Delacenserie: Congratulations for that amazing recognition from Wal-Mart. It's very exciting that we are on the radar and making deep inroads with Walmart. I'm on the retail committee of Walmart and can concur with Tom's point that we must be willing and able to comply with their accounting, reporting, inventory management, and other procedures. Tom, let's get the vendor side of that question.

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T. Stanek: First and foremost, IGT wants to support our customers which is you, the lottery operators. I do think our customers want us to bring ideas for how to build the business even if it introduces risks. We do everything we can to harness the global data-base of information that helps us to understand the best approach, to measure and minimize risk, and be flexible to explore the pros and cons to different action-plans. In the end, though, we all need to accept some measure of calculated risk. Fortunately, the risks are manageable and the damage to our market position by failing to invest should be adequate motivation to push hard to invest in modernizing technologies.

An example of pushing hard is what Gary did in Texas by insisting that IGT, Pollard Banknote, and Schafer Systems sit down together and collaborate to develop a solution for in-lane instant tickets; should they be fan-folded or not, where exactly is the POS in the lane, etc. Challenging us to collaborate and create a solution will allow the industry as whole to benefit.

G. Grief: Thank you for that, Tom. Some of you are too young to remember the time when we had to order the telephone land-line prior to moving into a house or apartment. That was the first thing we did. We didn't call it a land-line since there were no other kinds of lines. Similarly, I wonder how long it will be before we look back nostalgically at the time when lottery ticket purchases were processed by a dedicated lottery terminal. That may be where in-lane sales is taking us. We can appreciate and very much respect the willingness of our commercial partners to self-disrupt and partner with us in our journey to modernize, even when it is not always in their short-term best interests.

T. Stanek: It's a team effort and IGT is in it for the long-game.

T. Delacenserie: I second Gary's commendation of our vendor partners. They're the ones assuming more of the risk, and more of the cost to self-disruption. But it is a team effort and there really is no alternative to adapting to market-changes. If Plan B is to end up like Eastman Kodak, then we all need to work together and assume the risk, make the investment in modernizing innovation and the technologies that will keep us aligned with our players and our channel partners.

It comes down to disrupt or be disrupted. Thank you, ladies and gentlemen, and thank you panelists!

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easily justifies the investment. Alternatively, we can create a contract that allocates a percentage of sales towards the purchase of the system. We've also developed a retail participation tool to help lotteries negotiate a cost-sharing program with their retailers. We have several different cost-sharing models that incentivize retailers to optimize performance.

Is the data also made available to the lottery sales reps who call on the retailers?

R. Lex: Absolutely. The lottery sales rep is equipped with all the granular detail and solutions and a focus on improving performance. No wasted time to ask questions of a store manager whose time is very limited. And this is just the beginning, the foundational platform that will soon enable single-ticket activation, along with single ticket billing and auditing, and data-mining that will open up entirely new avenues for growth. Having this data unlocks the ability to roll out best practices exponentially – and roll out in warp speed.

For instance, we just installed *SCiQ* in 30 stores for an initial roll out in Ohio Kroger stores. The Ohio Lottery and Kroger asked us for the sales data from those stores. We were able to provide it instantly, as well as give them the ability to access the data anytime anywhere, which motivated them to green-light a *SCiQ* roll out to all 150 plus Kroger stores in Ohio.

What are the obstacles to unlocking the resources and the willingness to invest in modernization?

W. Eisele: It's largely a matter of just making the case for why investing in modernizing technologies and products produces a short-term financial ROI as well as the platform for long-term sustainable growth. Compare investment in retail modernization to investment in a new lottery game. It is readily apparent when a game performs well. Other lotteries see that success, learn from it, and work to replicate that success in their own markets. Best-practices in game development spread quickly, being widely adopted in a timely manner. That is not true in the application of new technologies and products to support the distribution of lottery products. In markets where modernization initiatives like *SCiQ* and *PlayCentral 54* are being adopted, it's a strategic part of the overall business plan to drive sales growth and increasing the gap between the best performing lotteries and under-performing lotteries. So it's largely just a matter of getting the word out.

And we're here today doing just that.

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SCiQ®

- Intelligent lottery retail technology ecosystem
- Revolutionizes the way lottery products are sold
- Pilots have run in 10 U.S. states (AZ, FL, GA, ME, NY, NC, OH, PA, SC, TX) with major retailers, incl. Walmart, Kroger, Circle K and 7-Eleven
- First comprehensive, in-store lottery technology to offer lotteries and retailers:
- Single ticket tracking and Inventory control
  - Product security
  - Increased speed-of-service
  - Modernized merchandising
  - Simplified accounting functions
  - Unit level, real-time data down to the individual customer's lottery shopping cart
- Consumers benefit from touch-of-a-button ease and convenience
- Mobile advance pre-order capable
- Single ticket activation and billing capable

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- Scientific Games named 2019 Walmart Supplier of the Year for Product (*PlayCentral 54*)
- Industry's first reduced height lottery self-service machine in market (May 2018)
- Custom-designed for Walmart Super Centers self-checkout areas
- PlayCentral machines are the first self-service machines offering full portfolio of lottery products: instant, draw and high-frequency draw games
- PlayCentral machines are the first self-service machines offering purchase of lottery games with cash, debit card or mobile payment (i.e. Google Pay or Apple Pay).
- PlayCentral machines are the first Payment Card Industry (PCI)-certified card and mobile payment options