

SMALL-BALL VERSUS THE NEXT BIG THING

TRADITIONAL LOTTERY THRIVES ON INCREMENTAL IMPROVEMENTS AND “SMALL-BALL” WINS



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Following is an edited transcript of the presentation by Gordon Medenica at PGRI Lottery Expo NYC on October 29, 2019 in New York. You can view a video of the complete panel discussion at PGRItalks.com.

What a difference a year makes.

A year ago at this time, the jackpots were rolling like crazy. The \$1.5 billion Mega Millions jackpot hit in South Carolina, and Hogan Brown and I were running around to all of the morning TV shows – it was one of the most exciting times of my lottery career. That was followed by the \$700 million Powerball jackpot. It just blew out everybody’s numbers; in fact, by the end of the fourth month of the fiscal year, we had basically made our numbers for the year.

But shortly thereafter, I starting thinking about how we were going to top those numbers the following year. Of course, we’re living through that now and it’s been sobering and quite an awakening.



I was originally going to speak about what lotteries can learn from other gaming entities, and then talk about where the lottery business stands in terms of the broader gaming industry. I’d like to start with the gaming industry and then go through a number of more familiar topics, along with some concepts and analysis.

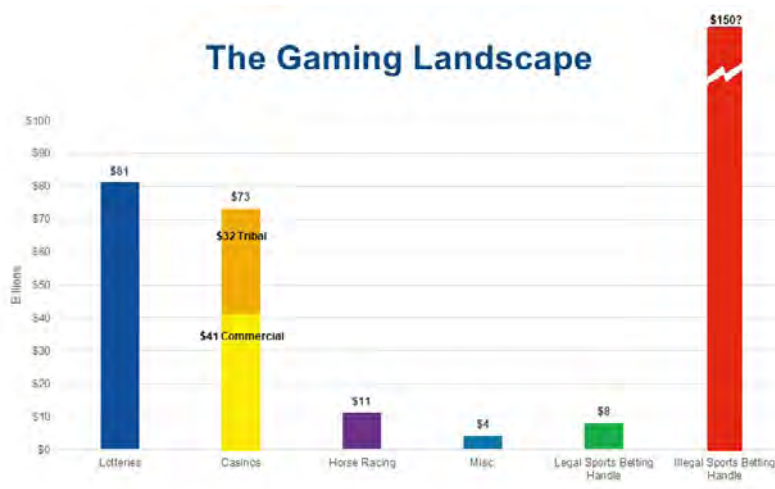
In the United States, the lottery business accounts for more than \$80 billion, and in terms of total size, the casino industry is very similar. While the casino business is bifurcated into tribal and commercial properties, that distinction is really invisible to the player. There’s a real debate on the question of how much we can learn from what’s going on in casinos -- but maybe the casinos are also learning from us; it’s not clear which way the creative inputs are flowing! Horse racing no longer has a viable business model

in the U.S. and it survives on direct subsidies from casinos. If you look at New York, Pennsylvania and Maryland, those subsidies add up to more than \$500 million, just in those three states. Many other states support horse racing, but mainly for political and employment reasons. Finally, there’s also a small category for miscellaneous that includes charitable gaming.

But then we come to sports betting, and everyone’s salivating at the notion that the illegal sports betting market may be \$150 billion. That \$150 billion figure is pulled out of the air – nobody really knows what the basis of it is, but it seems to be accepted. Nevertheless, it’s really important – especially when we talk to our legislators – that we distinguish between handle and the money that we actually take away from it. Sports betting is very low margin, and the \$150 billion probably doesn’t generate more than about \$10 billion in profit. So that bar on the chart shrinks tremendously when you start thinking about the internal economics of how that number is generated. The reason I mention it is because we, as lottery people, are always looking for the next big thing.

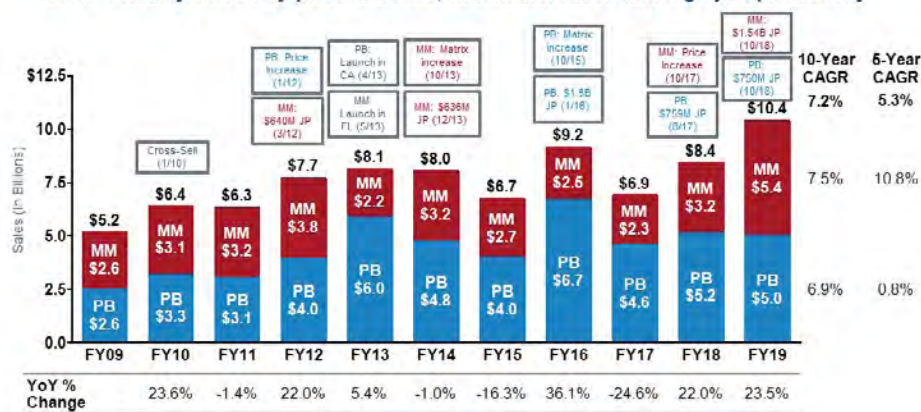
Historically, there have always been big things that drove this business. First, there was the shift from an illegal market to a legal market, and the daily numbers games were an impetus for the legalization of lotteries across the country. Then

The Gaming Landscape



Historical Mega Millions & Powerball Sales

Sales volatility driven by price increase, matrix increases and high jackpot activity



Note: Power Play and Megaplier sales have been included in sales. Fiscal Year is July through June.

instant games became a big growth lever through multiple price points and a ton of distribution. The big jackpot games gave us another giant lever of growth. So, we've had these big concepts in the past that have driven our growth, and now we're starting to see the limits of that.

Let's concentrate on Mega Millions and Powerball and look at their history since just before the cross-selling agreement began in FY2010. Of course, cross-selling itself was a tremendous boost for the industry. It took a lot of work to get there, but obviously it did extremely well. It's interesting to look at the events that have taken place over the past decade, which are noted in the boxes across the top of the chart.

Cross-selling was done with a very explicit strategy. The entire industry came together and agreed that the first step was to cross-sell both games in all jurisdictions. The second step was to take one or both games to a \$2 price point - that was already laid out back in 2010. The third step was to have a \$5 national game. While we've explored that concept, it hasn't happened yet, although it might still. Powerball began that second stage of the strategy by going to \$2 during FY2012 and we had a nice boost. That same year, we also had a \$656 million Mega Millions jackpot, which was a record at the time. So 2012 was a great year.

Interestingly, when cross-selling started, two very large states - Florida and California - chose not to participate. California had a successful in-state lotto game that sold for \$1, and they were afraid of the competition of selling too many lotto-style games. They explicitly said they weren't going to join until Powerball's price moved to \$2. California

and Florida joined in FY2013, and at that point all U.S. lotteries were selling both games.

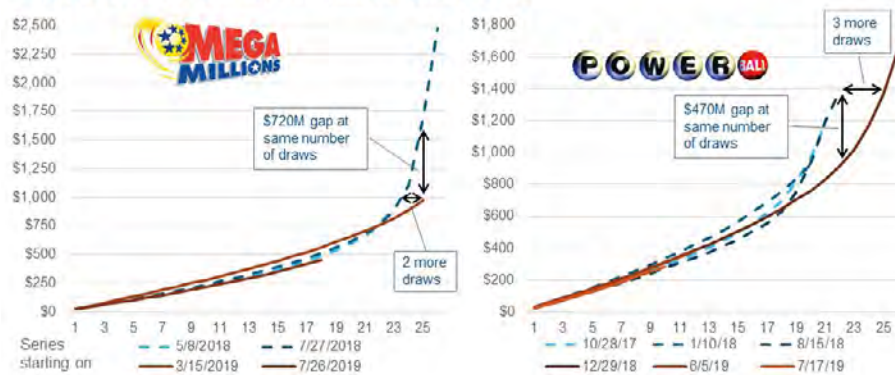
Mega Millions made matrix changes in FY2014, and there was some volatility, and sales dipped again in FY2015. Then in FY2016 Powerball had the world-record jackpot of almost \$1.6 billion. The jackpot category generated \$9.2 billion out of the

\$80 billion that represents the whole industry. The next change came in FY2018 when Mega Millions went to the \$2 price and there was a nice boost in sales of the two jackpot games, from \$6.9 billion to \$8.4 billion. Then, a year ago, Mega Millions had the \$1.5 billion jackpot. It had been two and a half years between the \$1.6 billion Powerball jackpot and the \$1.5 billion Mega Millions jackpot, and as a category, the jackpot games jumped to \$10.4 billion in total sales.

If you weren't an insider in this industry, you might look at those numbers and say, "Wow, look at those growth rates - this is a vibrant, healthy business." But, of course, we know that it's driven by these jackpots. A year later, we've all experienced jackpot fatigue, and as our sales decline, we're all trying to explain to our legislators and others why the numbers look so bad this year. But it's not that different from the volatility that we've always seen in this category. Of course, this is a category that's important to us because high jackpots are an entry point for infrequent players to jump in. But it's not that big a category in larger lotteries' portfolios. Even in Mary-

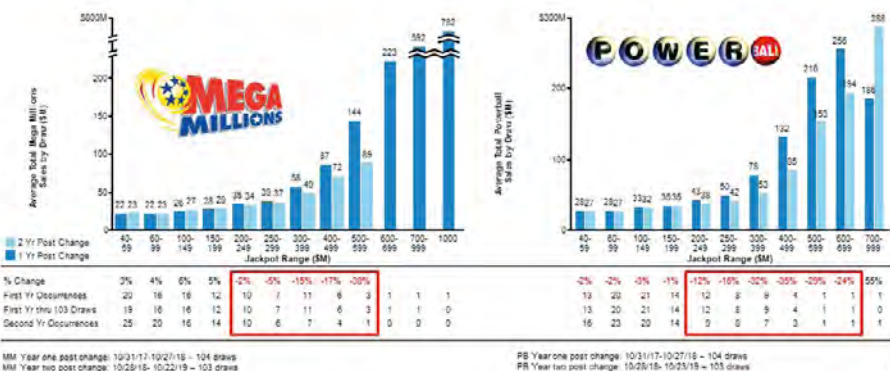
Mega Millions and Powerball Cumulative Series Sales

Because of the decline in sales at high jackpots, recent series have taken more draws to reach similar cumulative sales levels



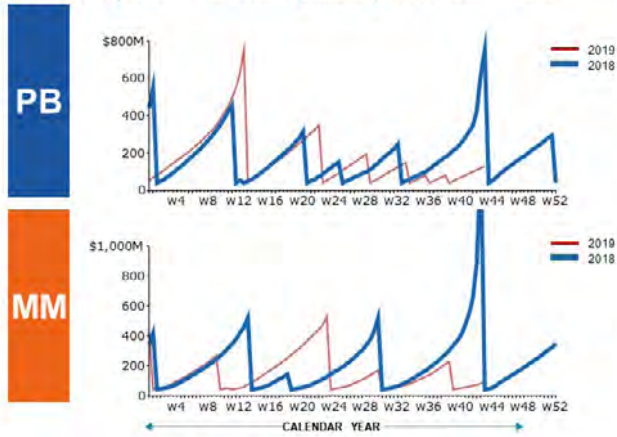
Mega Millions and Powerball Sales by Jackpot Level

Sales have declined significantly in the second year since the MM price change for both games at jackpot levels over \$200M



Multi-State Game Performance

Jackpot activity in 2019 has been significantly weaker than in 2018



DELTA TOTAL US
SALES 2019 vs. 2018
(\$, Million)

-\$432M

-\$2,242M

land, a medium-sized state, the jackpot games only account for about 10% of our sales. If you're a smaller state where jackpot games account for 40% or 50% of your sales, this is devastating, and your results are a giant rollercoaster. States where this category isn't as important will survive as the other major game categories continue to grow.

Sales building up to the big Mega Millions jackpot were off by about 40% from the sales building up to the big Powerball jackpot in

2016. Another way to think about the sales slowdown is to look at how many more draws it takes to get to the same jackpot level. In Mega Millions, it takes about two more draws, and for Powerball, it takes about three more draws. We are still the dominant gaming entity in this field in North America, but do these numbers give any indication that this is the beginning of the decline? Have we seen our best days? How do we go forward from here?

We have a bunch of little games, and, thanks to Drew Svitko, we tried something new with one of them. Drew pushed the Cash4Life consortium, which represents nine Cash4Life states, to think about going to daily drawings. He had done that with one of his games in Pennsylvania. The group was initially skeptical, but the argument that carried the day was, "What have we got to lose?" We made the change, and sales have been up 60, 80, 90% in various jurisdictions with very minimal cannibalization. We held a joint meeting with the Lucky For Life consortium, which is very interested in our success with going daily. We hope they will come along to do that, and down the road, we may redesign the game with the objective that it become an even bigger national game.

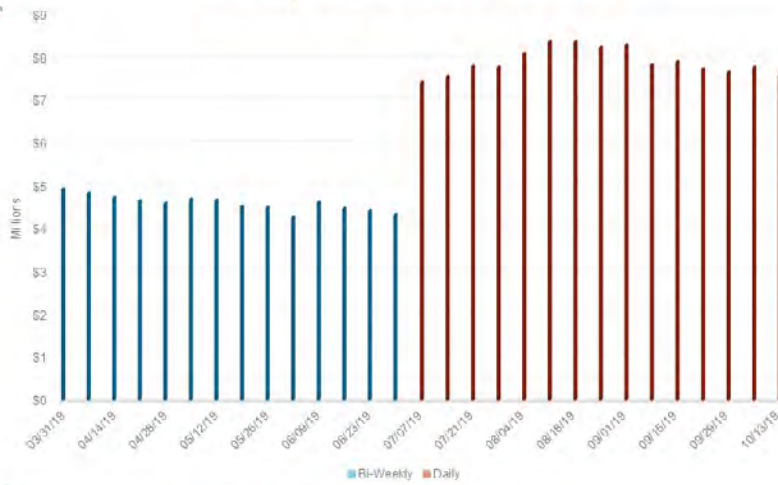
This brings up other initiatives that are going on in the industry – there are tons of them. However, I would characterize them as "small ball." Baseball fans know that small ball is about hitting singles, stealing bases and bunting to advance baserunners and just eking out one run at a time as opposed to hitting home runs. One of the big questions for our industry is can we develop another huge breakthrough concept – like the national

Connecting. Listening. Partnering.

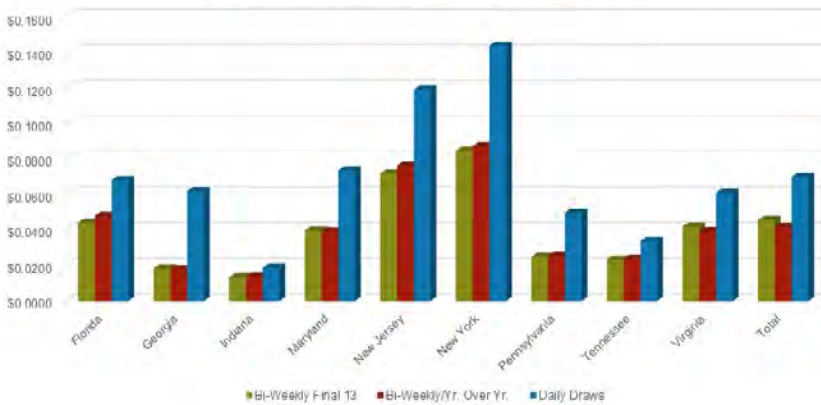
WE HELPED YOU CONNECT WITH YOUR PLAYERS. We listened to you about your business wants and needs. And we are honored to partner with so many of you across the gaming industry. As we bring the connected casino of the future to the market through FUZION®, we will continue to listen to you, innovate for you, and bring you new solutions to make your operations more efficient and more profitable than ever.



Weekly C4L Sales - All States



Cash4Life Weekly Per Capita Before & After Daily Conversion



jackpot games, instant games or price point adjustments – or do we have to play small ball? And if we play small ball, can we ever do something as significant as one of those giant breakthrough concepts?

Industry-Wide Initiatives

(Small-Ball?)

- In-Lane
- Cashless
- Double Play
- Sports Betting
- Route Management
- Fast Play
- International
- Retail Expansion
- Promotion Efforts (e.g. New Year's)
- Online

I was lucky to be asked to join the International Working Group, and in that group, we started by thinking of really big game concepts. We were thinking about international Powerball, international Mega Millions, jackpots starting at \$200 million, and having \$500 million or \$1 billion jackpots regularly. We're not afraid to take an existing idea that we can use to our benefit. We looked at the Lottoland model of an

insurance-backed prize pool in order to get us over the initial hurdle of the liquidity problem at the early stages. All in all, there was a lot of work put into big-concept international games, as a potential way of expanding significantly and quickly. Nobody really knows how big it could be, and there are a ton of operational, financial, tax and legal issues that are being worked through.

Another initiative is in Texas, where they are launching in-lane sales. It's all well and good to have Mega Millions and Powerball for sale in-lane, but selling instants in-lane is where the real money is going to come from. Are we going to have the patience on in-lane sales if initial results aren't as spectacular as we think they will be? Will we hang in there and develop the rest of our portfolio to be relevant in an in-lane environment?

Cashless payment is another option where we've seen great results. For years, everyone was reluctant to do that because of the bank

fees. Now, we've become convinced that the bank fees shouldn't be a barrier, and to the extent that lotteries have to absorb those fees, it should be more than offset by the sales increases that can be generated.

Double Play is a little add-on game that Mega Millions has approved. We've got five states launching in April and a few more next fall. Mega Millions now has three add-ons, including Megaplier and Just The Jackpot, which is still out there. Maybe Powerball will choose to offer some of these add-ons as well.

When it comes to sports betting, we have to be realistic that it may not be a game-changer, especially in terms of bottom-line profitability. It's important for us, but it's especially important for the casino business where they view sports betting as a traffic driver, not a profit driver. Hopefully many of us will be participating in sports betting very shortly, but I think it's going to be additive, and not a game-changer.

Our industry has had some talks with CVS about their business model, and the potential for adding lottery sales at thousands of CVS stores around the country. Retail expansion, of course, is critical for us and that could be another way to achieve growth. There are 18 states selling Fast Play, a draw game that has the characteristics of instants where players find out immediately if they've won. And how much of a role is there for promotions? We're all familiar with the New Year's Eve promotion that Powerball is doing – is that something that we, as an industry, need to embrace and fund and pay for? We're happy to see those types of experiments and see if they can, in fact, move the needle.

And there's also iLottery online. We've seen in Michigan and Pennsylvania that if you're willing to go to the high payout instant model, you can drive significant revenue in that category. However, the states that are selling existing products at existing payouts – allowing players to buy Mega Millions or Powerball online – that's not a game-changer.

There are 10 ideas here, and we could probably add another 10 that several states are doing. Even if each of these ideas only generate 1% or 2% of growth, and if you do everything on the list, then you can add up to 10% to 20% growth. I would argue that in an industry of this size and maturity, that may be where our future growth comes from.

Thanks very much.