

SCIENTIFIC GAMES CORP

Form 10-Q

November 08, 2006

## **UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D. C. 20549

## Form 10-Q

{Mark One}

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from        to

Commission file number: 0-13063

# SCIENTIFIC GAMES CORPORATION

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**81-0422894**

(I.R.S. Employer Identification No.)

**750 Lexington Avenue, New York, New York 10022**

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

(Address of principal executive offices)

(Zip Code)

(212) 754-2233

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 7, 2006:

Class A Common Stock: 91,608,161

Class B Common Stock: None

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS  
AND OTHER INFORMATION**

**THREE MONTHS ENDED SEPTEMBER 30, 2006**

**PART I. FINANCIAL INFORMATION**

Item 1. Consolidated Financial Statements:

Balance Sheets as of December 31, 2005 and September 30, 2006

Statements of Income for the Three Months Ended September 30, 2005 and 2006

Statements of Income for the Nine Months Ended September 30, 2005 and 2006

Condensed Statements of Cash Flows for the Nine Months Ended September 30, 2005 and 2006

Notes to Consolidated Financial Statements

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

**PART II. OTHER INFORMATION**

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 6. Exhibits

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

(Unaudited, in thousands, except per share amounts)

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

	December 31, 2005	September 30, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 38,942	37,817
Accounts receivable, net of allowance for doubtful accounts of \$6,149 and \$7,062 at December 31, 2005 and September 30, 2006, respectively	129,250	162,003
Inventories	40,148	63,877
Deferred income taxes	14,242	23,018
Prepaid expenses, deposits and other current assets	31,971	44,810
Total current assets	254,553	331,525
Property and equipment, at cost	666,469	775,108
Less accumulated depreciation	300,250	342,691
Net property and equipment	366,219	432,417
Goodwill, net	339,169	574,782
Other intangible assets, net	87,289	138,359
Other assets and investments	125,283	152,140
Total assets	\$ 1,172,513	1,629,223
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Current installments of long-term debt	\$ 6,055	3,256
Accounts payable	54,223	47,776
Accrued liabilities	80,305	118,623
Interest payable	779	5,078
Total current liabilities	141,362	174,733
Deferred income taxes	9,759	8,249
Other long-term liabilities	59,879	68,290
Long-term debt, excluding current installments	574,680	878,515
Total liabilities	785,680	1,129,787
Commitments and contingencies		
Stockholders equity:		
Class A common stock, par value \$0.01 per share, 199,300 shares authorized, 89,869 and 91,434 shares outstanding at December 31, 2005 and September 30, 2006, respectively	899	914
Class B non-voting common stock, par value \$0.01 per share, 700 shares authorized, none outstanding		
Additional paid-in capital	425,750	457,205
Accumulated earnings (losses)	(33,309)	25,565
Treasury stock, at cost	(9,556)	(9,556)
Accumulated other comprehensive income	3,049	25,308
Total stockholders equity	386,833	499,436
Total liabilities and stockholders equity	\$ 1,172,513	1,629,223

See accompanying notes to consolidated financial statements.



**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**Three Months Ended September 30, 2005 and 2006**  
**(Unaudited, in thousands, except per share amounts)**

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

	2005	2006
Operating revenues:		
Services	\$ 155,925	198,921
Sales	40,899	18,469
	196,824	217,390
Operating expenses		
Cost of services (exclusive of depreciation and amortization)	86,956	107,265
Cost of sales (exclusive of depreciation and amortization)	30,064	13,406
Selling, general and administrative expenses	31,489	34,676
Depreciation and amortization	17,130	36,424
Operating income	31,185	25,619
Other deductions:		
Interest expense	7,139	12,154
Equity in net (income) loss in joint ventures	60	(1,722 )
Other (income) loss, net	(530 )	10
	6,669	10,442
Income before income tax expense	24,516	15,177
Income tax expense	5,331	3,650
Net income	\$ 19,185	11,527
Basic and diluted net income per share:		
Basic net income available to common stockholders	\$ 0.21	0.13
Diluted net income available to common stockholders	\$ 0.21	0.12
Weighted average number of shares used in per share calculations:		
Basic shares	89,689	91,346
Diluted shares	92,890	94,433
See accompanying notes to consolidated financial statements.		

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF INCOME**

**Nine Months Ended September 30, 2005 and 2006**  
**(Unaudited, in thousands, except per share amounts)**

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

	2005	2006
Operating revenues:		
Services	\$ 472,546	590,113
Sales	106,258	75,043
	578,804	665,156
Operating expenses		
Cost of services (exclusive of depreciation and amortization)	259,637	320,808
Cost of sales (exclusive of depreciation and amortization)	75,841	57,198
Selling, general and administrative expenses	84,942	102,414
Depreciation and amortization	48,724	79,241
Operating income	109,660	105,495
Other deductions:		
Interest expense	20,361	30,471
Equity in net (income) loss in joint ventures	1,558	(6,455 )
Other income, net	(1,252 )	(859 )
	20,667	23,157
Income before income tax expense	88,993	82,338
Income tax expense	24,029	23,464
Net income	\$ 64,964	58,874
Basic and diluted net income per share:		
Basic net income available to common stockholders	\$ 0.73	0.65
Diluted net income available to common stockholders	\$ 0.70	0.62
Weighted average number of shares used in per share calculations:		
Basic shares	89,118	90,909
Diluted shares	92,293	94,795
See accompanying notes to consolidated financial statements.		

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**Nine Months Ended September 30, 2005 and 2006**  
**(Unaudited, in thousands)**

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

	2005	2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 64,964	58,874
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>		
Depreciation and amortization	48,724	79,241
Change in deferred income taxes	2,802	(7,423 )
Share-based compensation		14,035
Tax benefit from exercise of employee stock options	7,295	
Changes in operating assets and liabilities, net of effects of acquisitions	(31,927 )	(38,494 )
Change in short-term investments	47,475	
Other	9,439	(2,697 )
Net cash provided by operating activities	148,772	103,536
<b>Cash flows from investing activities:</b>		
Capital expenditures	(14,426 )	(12,360 )
Wagering systems expenditures	(72,391 )	(96,777 )
Other intangible assets and software expenditures	(13,571 )	(33,012 )
Change in other assets and liabilities, net	(12,509 )	(18,006 )
Business acquisitions, net of cash acquired	(24,774 )	(263,659)
Net cash used in investing activities	(137,671 )	(423,814)
<b>Cash flows from financing activities:</b>		
Borrowings (repayments) under revolving credit facility	(22,750 )	155,500
Borrowings (repayments) of long-term debt	(6,377 )	145,392
Excess tax benefit from equity-based compensation plan		4,487
Net proceeds from issuance of common stock	6,803	12,607
Net cash provided by (used in) financing activities	(22,324 )	317,986
Effect of exchange rate changes on cash and cash equivalents	(4,466 )	1,167
Increase (decrease) in cash and cash equivalents	(15,689 )	(1,125 )
Cash and cash equivalents, beginning of period	66,120	38,942
Cash and cash equivalents, end of period	\$ 50,431	37,817
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 13,579	24,304
Income taxes, net of refunds	\$ 2,394	26,618

See accompanying notes to consolidated financial statements.

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited, in thousands, except per share amounts)

**Notes to Consolidated Financial Statements**

**(1) Consolidated Financial Statements**

*Basis of Presentation*

The consolidated balance sheet as of September 30, 2006, the consolidated statements of income for the three and nine months ended September 30, 2005 and 2006, and the consolidated condensed statements of cash flows for the nine months ended September 30, 2005 and 2006, have been prepared by Scientific Games Corporation (together with its consolidated subsidiaries, the Company) without audit. In the opinion of management, all adjustments necessary to present fairly the consolidated financial position of the Company at September 30, 2006 and the results of its operations for the three and nine months ended September 30, 2005 and 2006 and its cash flows for the nine months ended September 30, 2005 and 2006 have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2005 Annual Report on Form 10-K. The results of operations for the period ended September 30, 2006 are not necessarily indicative of the operating results for the full year.

*Basic and Diluted Net Income Per Share*

## Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

The following represents a reconciliation of the numerator and denominator used in computing basic and diluted net income per share available to common stockholders for the three and nine months ended September 30, 2005 and 2006:

	Three months ended September 30,		Nine months ended September 30,	
	2005	2006	2005	2006
<b>Income (numerator)</b>				
Net income (basic)	\$ 19,185	11,527	\$ 64,964	58,874
<b>Shares (denominator)</b>				
Basic weighted average common shares outstanding	\$ 89,689	91,346	89,118	90,909
Effect of dilutive securities-stock options, warrants and deferred shares	3,201	2,409	3,175	2,719
Effect of dilutive shares related to convertible debentures		678		1,167
Diluted weighted average common shares outstanding	\$ 92,890	94,433	92,293	94,795
<b>Basic and diluted per share amounts</b>				
Basic net income per share available to common stockholders	\$ 0.21	0.13	\$ 0.73	0.65
Diluted net income per share available to common stockholders	\$ 0.21	0.12	\$ 0.70	0.62

The weighted-average diluted shares outstanding for the three- and nine-month periods ended September 30, 2006 excludes the effect of approximately 553,043 and 87,903 out-of-the-money options, respectively, as their effect would be anti-dilutive. The weighted-average diluted common shares outstanding for the three- and nine-month periods ended September 30, 2005, excludes the effect of approximately 40,434 and 405,020 out-of-the-money, respectively, as their effect would be anti-dilutive.

The aggregate number of shares that the Company could be obligated to issue upon conversion of its \$275,000, 0.75% convertible senior subordinated debentures due 2024 (the Convertible Debentures), which the Company sold in December 2004, is approximately 9,450. The Convertible Debentures provide for net share settlement upon exercise and the Company has purchased a bond hedge to mitigate the potential economic dilution from conversion. During the second and third quarters of 2006, the average price of the Company's common stock exceeded the specified conversion price. For the three and nine months ended September 30, 2006, the Company has included 678 and 1,167 shares, respectively, related to its Convertible Debentures in its diluted weighted average common shares outstanding. Such

shares were excluded from the three and nine months ended September 30, 2005 calculation, as they were anti-dilutive. The Company has not included the offset from the bond hedge as it would be anti-dilutive; however, when the Convertible Debentures mature, the diluted share amount will decrease because the bond hedge will offset the economic dilution from conversion.

**(2) Acquisitions**

On April 20, 2006, the Company acquired The Global Draw Limited and certain related companies ( Global Draw ). Global Draw is a leading United Kingdom supplier of fixed odds betting terminals and systems, and interactive sports betting systems and also operates terminals and betting systems in Austria and the United Kingdom. The Company expects that the acquisition of Global Draw will strengthen its role in the worldwide sports betting and video lottery business. The purchase price was approximately \$183 million (subject to adjustment), plus an earn-out to the selling shareholders, as well as contingent bonuses to certain members of the management team, based on the future financial performance of the business. The aggregate amount of such payments would total one-third of an amount equal to Global Draw's EBITDA (EBITDA, for such purposes, is defined as the consolidated earnings before interest, tax, depreciation and amortization) for the year ended December 31, 2008 multiplied by a specific price multiple depending on the level of EBITDA earned. In accordance with current accounting standards, any such payments made to selling shareholders will be capitalized as additional purchase price and any such payments made to management will be expensed. The acquisition was recorded using the purchase method of accounting. Approximately \$2 million of the preliminary estimate of goodwill of approximately \$152 million from the acquisition of Global Draw is deductible for tax purposes. All other assets and liabilities acquired in the transaction were included in the preliminary purchase price allocation. The Company financed the acquisition through a combination of borrowings under its existing revolving credit facility and a new \$100,000 term loan. The operating results of Global Draw have been included in the Company's Diversified Gaming segment since the beginning of the second quarter of 2006. The following table represents the unaudited pro forma results of operations for the three and nine months ended September 30, 2005 and 2006 as if the transaction had occurred at the beginning of the periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2006	2005	2006
Operating revenues	\$ 214,657	217,390	\$ 642,764	710,607
Operating income	\$ 36,130	25,619	\$ 135,640	128,635
Net income	\$ 21,071	11,527	\$ 78,384	73,507
Basic net income per share	\$ 0.24	0.13	\$ 0.88	0.81
Diluted net income per share	\$ 0.23	0.12	\$ 0.85	0.78

These pro forma results have been prepared for comparative purpose and do not purport to be indicative of what would have occurred had the acquisition been consummated on January 1, 2005, or the results that may occur in the future.

On April 5, 2006, the Company acquired certain assets of The Shoreline Star Greyhound Park and Simulcast Facility ( Shoreline ) located in Bridgeport, Connecticut. The Company expects that the acquisition of Shoreline will allow it to maximize the potential of its Connecticut operations. Additionally, the deal eliminates existing restrictions on the Company's ability to simulcast live racing in certain portions of the state. The purchase price was approximately \$12 million (subject to adjustment) plus an earn-out, based on the future financial performance of the business. The Company paid cash for the acquisition which was recorded using the purchase method of accounting. The operating results of Shoreline are included in the Diversified Gaming segment and have been included in the Company's Statement of Operations since the date of acquisition. The acquisition of Shoreline was not material to the Company's operations.

On March 22, 2006, the Company acquired substantially all of the online lottery assets of Swedish firm EssNet AB ( EssNet ) which specializes in online lottery systems and terminals to run online lotteries, sports betting, instant tickets and mobile games on a national level. EssNet's lottery customers include seven states in Germany, the national lottery of Norway, Golden Casket and Tattersall's Lottery in Australia, and other national lotteries. The Company expects that its acquisition of EssNet will enable it to further expand into the European lottery market. The purchase price was approximately \$60 million in cash. The acquisition was recorded using the purchase method of accounting. The operating results of EssNet are included in the Lottery Systems segment and have been included in the Company's Statements of Operations since the date of acquisition. Approximately \$55 million of the preliminary estimate of goodwill of approximately \$75 million from the acquisition of EssNet is deductible for tax.

purposes. Additionally, other assets and liabilities acquired in the transaction, such as certain intangible assets, property and equipment, current assets and liabilities were included in the preliminary purchase price allocation. The acquisition of EssNet was not material to the Company's operations.

In conjunction with the purchase of EssNet, the Company has a plan to integrate certain operating locations as part of the integration of EssNet. The Company has recorded approximately \$27 million in liabilities, primarily related to involuntary employee terminations, termination of leases and termination of service contracts that will result from the integration.

The table below summarizes the payments made to date, adjustments and the balance of the accrued integration costs as of and for the period ended September 30, 2006 (in thousands):

<b>Cost Summary</b>	<b>Accrued Costs at Closing</b>	<b>Payments</b>	<b>Adjustments to Goodwill</b>	<b>Accrued Balance September 30, 2006</b>
Severance pay and benefits	17,644	(5,245 )	(6,163 )	6,236
Lease termination	1,475	(501 )		974
Contractual obligations	7,598	(4,111 )	2,653	6,140
	26,717	(9,857 )	(3,510 )	13,350

In the third quarter of 2006, the Company received an extension to the term of its option to acquire 69% of the shares of International Lotto Corp., SRL ( ILC ) from September 30, 2006 to November 30, 2006. ILC is a member of a consortium agreement with certain charities in Peru which gives them the right to participate in the operation of a lottery. The Company's option to acquire 69% of the shares of ILC was granted as consideration for approximately \$15.5 million of advances made to ILC since December 2003.

### (3) Operating Segment Information

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information ( SFAS No. 131 ), defines operating segments to be those components of a business for which separate financial information is available that is regularly evaluated by management in making operating decisions and in assessing performance. SFAS No. 131 further requires that segment information be presented consistently with the basis and manner in which management internally disaggregates financial information for the purposes of assisting in making internal operating decisions.

As previously reported in its Quarterly Report on Form 10-Q for the quarter ended March 31, 2006, the Company determined that its previously reported segments consisting of Lottery, Pari-mutuel, Venue Management and Telecommunications Products no longer reflected the way the Company managed the business. Beginning in the first quarter of 2006, the Company began reporting its business in three segments Printed Products, Lottery Systems and Diversified Gaming. The Printed Products segment includes the instant lottery ticket business and the pre-paid phone card business (formerly the Telecommunications Product Group). The Lottery Systems segment includes the Company's online lottery business. The Diversified Gaming segment includes the Company's pari-mutuel wagering systems business (formerly the Pari-mutuel Group) and the Company's off-track wagering business (formerly the Venue Management Group). All prior period amounts have been restated to conform to the current segment reporting format.

The Printed Products Group provides instant ticket and related services that includes ticket design and manufacturing as well as value-added services, including game design, sales and marketing support, inventory management and warehousing and fulfillment services. Additionally this division provides lotteries with over 80 licensed brand products and includes prepaid phone cards for cellular phone service providers. The Lottery Systems Group offers online, instant and video lottery products and online and instant ticket validation systems. Its business includes the supply of transaction processing software for the accounting and validation of both instant and online lottery games, point-of-sale terminal hardware sales, central site computers and communication hardware sales, and ongoing support and maintenance for these products. The Diversified Gaming Group provides computerized wagering systems and services such as race simulcasting and communications services and telephone and internet account wagering to the pari-mutuel wagering industry. It owns and operates licensed pari-mutuel wagering facilities in Connecticut, Maine and the Netherlands. Additionally, with the acquisition of Global Draw, this division is a supplier of fixed odd betting terminals and systems, and interactive sports betting terminals and systems throughout Europe.



Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

In the quarter ended September 30, 2006, the Company recorded a \$10,200 charge in its Diversified Gaming segment related to the impairment of certain hardware and software assets in the pari-mutuel business as a result of the roll-out of our new terminal and two Quantum Data Centers and the write-off of hardware and accrual of losses of \$500 on certain under-performing pari-mutual contracts. Of this amount, approximately \$9,700 was recorded as depreciation and amortization and approximately \$500 was recorded as cost of services in the Company's Statement of Operations for the quarter ended September 30, 2006.

The following tables represent revenues, profits, depreciation, amortization, and capital expenditures for the three and nine month periods ended September 30, 2005 and 2006, by current reportable segments. Corporate expenses, interest expense and other (income) deductions are not allocated to the reportable segments. All prior period amounts have been restated to reflect the current reportable segments.

	Three Months Ended September 30, 2005 (Unaudited)			Totals
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	
Service revenues	\$ 79,107	42,318	34,500	155,925
Sales revenues	16,854	21,760	2,285	40,899
Total revenues	95,961	64,078	36,785	196,824
Cost of services (exclusive of depreciation and amortization)	40,669	21,700	24,587	86,956
Cost of sales (exclusive of depreciation and amortization)	12,185	15,742	2,137	30,064
Selling, general and administrative expenses	10,698	7,159	6,472	24,329
Depreciation and amortization	4,547	8,829	3,460	16,836
Segment operating income	\$ 27,862	10,648	129	38,639
Unallocated corporate expense				7,454
Consolidated operating income				\$ 31,185
Capital and wagering systems expenditures	\$ 1,676	35,063	6,645	43,384

**Three Months Ended September 30, 2006**

**(Unaudited)**

	<b>Printed Products Group</b>	<b>Lottery Systems Group</b>	<b>Diversified Gaming Group</b>	<b>Totals</b>
Service revenues	\$ 91,135	50,877	56,909	198,921
Sales revenues	10,619	7,205	645	