

SCIENTIFIC GAMES CORP  
Form 10-Q  
November 04, 2008  
[Table of Contents](#)

**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, 2008

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**

(Exact name of registrant as specified in its charter)

Delaware

81-0422894

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

(State or other jurisdiction of  
incorporation or organization)

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

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

(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 required 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, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

The registrant has the following number of shares outstanding of each of the registrant's classes of common stock as of October 31, 2008:

Class A Common Stock: 92,877,876

Class B Common Stock: None

Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**INDEX TO FINANCIAL INFORMATION**

**AND OTHER INFORMATION**

**THREE MONTHS ENDED SEPTEMBER 30, 2008**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

Consolidated Balance Sheets as of September 30, 2008 and December 31, 2007

Consolidated Statements of Income for the Three Months Ended September 30, 2008 and 2007

Consolidated Statements of Income for the Nine Months Ended September 30, 2008 and 2007

Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007

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 1. Legal Proceedings**

**Item 1A. Risk Factors**

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

**Item 6. Exhibits**

Table of Contents

**Forward-Looking Statements**

Throughout this Quarterly Report on Form 10-Q we make forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements describe future expectations, plans, results or strategies and can often be identified by the use of terminology such as may, will, estimate, intend, continue, believe, expect, anticipate, could, potential, opportunity, or other similar terminology. The forward-looking statements contained in this Quarterly Report on Form 10-Q are generally located in the material set forth under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations but may be found in other locations as well. These statements are based upon management's current expectations, assumptions and estimates and are not guarantees of future results or performance. Actual results may differ materially from those projected in these statements due to a variety of risks and uncertainties and other factors, including, among other things: competition; material adverse changes in economic and industry conditions in our markets; technological change; retention and renewal of existing contracts and entry into new contracts; availability and adequacy of cash flow to satisfy obligations and indebtedness or future needs; protection of intellectual property; security and integrity of software and systems; laws and government regulation, including those relating to gaming licenses, permits and operations; inability to identify, complete and integrate future acquisitions; seasonality; dependence on suppliers and manufacturers; factors associated with foreign operations; dependence on key personnel; failure to perform on contracts; resolution of pending or future litigation; labor matters; and stock price volatility. Additional information regarding risks and uncertainties and other factors that could cause actual results to differ materially from those contemplated in forward-looking statements is set forth from time to time in our filings with the SEC, including under the heading Risk Factors in our most recent Annual Report on Form 10-K and in this Quarterly Report on Form 10-Q. Forward-looking statements speak only as of the date they are made, and except for our ongoing obligations under the U.S. federal securities laws, we undertake no obligation to publicly update any forward-looking statements whether as a result of new information, future events or otherwise.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

As of September 30, 2008 and December 31, 2007

(Unaudited, in thousands, except per share amounts)

**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements**

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 161,770	\$ 29,403
Accounts receivable, net of allowance for doubtful accounts of \$8,860 and \$9,184 as of September 30, 2008 and December 31, 2007, respectively	241,237	203,074
Inventories	91,686	92,565
Deferred income taxes, current portion	15,849	15,929
Prepaid expenses, deposits and other current assets	72,171	56,906
Total current assets	582,713	397,877
Property and equipment, at cost	1,084,272	966,291
Less accumulated depreciation	(454,302)	(404,667)
Net property and equipment	629,970	561,624
Goodwill, net	702,032	716,856
Intangible assets, net	116,198	133,030
Other assets and investments	326,028	290,652
Total assets	\$ 2,356,941	\$ 2,100,039
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Debt payments due within one year	\$ 53,488	\$ 4,942
Accounts payable	65,991	64,108
Accrued liabilities	153,379	148,464
Total current liabilities	272,858	217,514
Deferred income taxes	52,632	51,661
Other long-term liabilities	89,320	97,024
Long-term debt, excluding current installments	1,217,594	1,072,625
Total liabilities	1,632,404	1,438,824
Commitments and contingencies		
Stockholders equity:		
Class A common stock, par value \$0.01 per share, 199,300 shares authorized, and 92,877 and 93,414 shares outstanding as of September 30, 2008 and December 31, 2007, respectively	929	934
Additional paid-in capital	551,294	521,902

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Accumulated earnings	171,636	97,323
Treasury stock, at cost, 2,140 and 1,140 shares held as of September 30, 2008 and December 31, 2007, respectively	(37,459)	(19,442)
Accumulated other comprehensive income	38,137	60,498
Total stockholders' equity	724,537	661,215
Total liabilities and stockholders' equity	\$ 2,356,941	\$ 2,100,039

See accompanying notes to consolidated financial statements.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****Three Months Ended September 30, 2008 and 2007****(Unaudited, in thousands, except per share amounts)**

	<b>Three Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating revenues:</b>		
Services	\$ 265,430	\$ 244,526
Sales	26,505	22,374
	291,935	266,900
<b>Operating expenses:</b>		
Cost of services (exclusive of depreciation and amortization)	157,480	141,935
Cost of sales (exclusive of depreciation and amortization)	17,257	15,874
Selling, general and administrative expenses	41,937	43,738
Depreciation and amortization	36,487	61,266
Operating income	38,774	4,087
<b>Other (income) expense:</b>		
Interest expense	17,659	15,975
Equity in earnings of joint ventures	(13,356)	(8,344)
Other income, net	(818)	(123)
	3,485	7,508
Income (loss) before income taxes	35,289	(3,421)
Income tax expense (benefit)	9,879	(543)
Net income (loss)	\$ 25,410	\$ (2,878)
<b>Basic and diluted net income per share:</b>		
Basic net income (loss) per share	\$ 0.27	\$ (0.03)
Diluted net income (loss) per share	\$ 0.27	\$ (0.03)
<b>Weighted-average number of shares used in per share calculations:</b>		
Basic shares	92,841	92,737
Diluted shares	94,626	92,737

See accompanying notes to consolidated financial statements.

Table of Contents

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

Nine Months Ended September 30, 2008 and 2007

(Unaudited, in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2008	2007
Operating revenues:		
Services	\$ 764,044	\$ 690,180
Sales	90,867	88,563
	854,911	778,743
Operating expenses:		
Cost of services (exclusive of depreciation and amortization)	440,394	388,380
Cost of sales (exclusive of depreciation and amortization)	63,808	64,815
Selling, general and administrative expenses	140,775	123,378
Depreciation and amortization	106,099	122,600
Operating income	103,835	79,570
Other (income) expense:		
Interest expense	45,962	43,141
Equity in earnings of joint ventures	(48,612)	(31,623)
Early extinguishment of long-term debt	2,960	
Other income, net	(1,513)	(166)
	(1,203)	11,352
Income before income taxes	105,038	68,218
Income tax expense	30,725	19,230
Net income	\$ 74,313	\$ 48,988
Basic and diluted net income per share:		
Basic net income per share	\$ 0.80	\$ 0.53
Diluted net income per share	\$ 0.79	\$ 0.51
Weighted-average number of shares used in per share calculations:		
Basic shares	92,933	92,440
Diluted shares	94,588	95,894

See accompanying notes to consolidated financial statements.



Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****Nine Months Ended September 30, 2008 and 2007****(Unaudited, in thousands, except per share amounts)**

	<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Net cash provided by operating activities	\$ 145,597	\$ 141,592
Cash flows from investing activities:		
Capital expenditures	(10,886)	(27,430)
Wagering system expenditures	(123,479)	(108,927)
Other intangible assets and software expenditures	(33,711)	(28,608)
Change in other assets and liabilities, net	(1,826)	(25,732)
Business acquisitions, net of cash acquired	(3,174)	(102,840)
Net cash used in investing activities	(173,076)	(293,537)
Cash flows from financing activities:		
Net borrowings (repayments) under revolving credit facility	(158,000)	(45,000)
Proceeds of issuance from long-term debt	797,243	200,000
Payments on long-term debt	(447,069)	(3,639)
Payment of financing fees	(15,085)	
Purchase of treasury stock	(18,017)	
Net proceeds from issuance of common stock	3,020	11,701
Net cash provided by financing activities	162,092	163,062
Effect of exchange rate changes on cash and cash equivalents	(2,246)	2,164
Increase in cash and cash equivalents	132,367	13,281
Cash and cash equivalents, beginning of period	29,403	27,791
Cash and cash equivalents, end of period	\$ 161,770	\$ 41,072

See accompanying notes to consolidating financial statements.

Table of Contents**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, 2008, the consolidated statements of income for the three and nine months ended September 30, 2008 and 2007, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2008 and 2007, have been prepared by Scientific Games Corporation and are unaudited. When used in these notes, the terms we, us, our and Company refer to Scientific Games Corporation and all entities included in our consolidated financial statements unless otherwise specified or the context otherwise indicates. In the opinion of management, all adjustments necessary to present fairly our consolidated financial position as of September 30, 2008, the results of our operations for the three and nine months ended September 30, 2008 and 2007 and our cash flows for the nine months ended September 30, 2008 and 2007 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 our 2007 Annual Report on Form 10-K. The results of operations for the period ended September 30, 2008 are not necessarily indicative of the operating results for a full year.

*Basic and Diluted Net Income Per Share*

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, 2008 and 2007:

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Income (numerator)</b>				
Net income (loss)	\$ 25,410	\$ (2,878)	\$ 74,313	\$ 48,988
<b>Shares (denominator)</b>				

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Weighted-average basic common shares outstanding	92,841	92,737	92,933	92,440
Effect of dilutive securities-stock rights	1,785		1,649	2,147
Effect of dilutive shares related to convertible debentures			6	1,307
Weighted-average diluted common shares outstanding	94,626	92,737	94,588	95,894
<b>Basic and diluted per share amounts</b>				
Basic net income (loss) per share	\$ 0.27	\$ (0.03)	\$ 0.80	\$ 0.53
Diluted net income (loss) per share	\$ 0.27	\$ (0.03)	\$ 0.79	\$ 0.51

The weighted-average diluted common shares outstanding for the three months ended September 30, 2008 and 2007 excludes the effect of approximately 3,744 and 1,511, respectively, weighted stock rights outstanding, because their effect would be anti-dilutive.

The aggregate number of shares that we could be obligated to issue upon conversion of the remaining \$273,782 in aggregate principal amount of our 0.75% convertible senior subordinated notes due 2024 (the Convertible Debentures), which were sold in December 2004, is approximately 9,408. The Convertible Debentures provide for net share settlement upon conversion. In December 2004, we purchased a bond hedge to mitigate the potential dilution from conversion of the Convertible Debentures during the term of the bond hedge.

Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(1) Consolidated Financial Statements (continued)**

During the third quarter of 2008, the average price of our common stock was lower than the conversion price of the Convertible Debentures. Therefore, no shares related to the Convertible Debentures were included in our weighted-average diluted common shares outstanding for the three months ended September 30, 2008. During the second quarter of 2008, the average price of the Company's common stock exceeded the conversion price of the Convertible Debentures, therefore, we have included approximately 6 shares related to our Convertible Debentures in our weighted-average diluted common shares outstanding for the year-to-date period ended September 30, 2008.

During the third quarter of 2007, the average price of the Company's common stock exceeded the conversion price of the Convertible Debentures, however, due to the net loss for the quarter ended September 30, 2007, we did not include 1,669 potentially dilutive shares related to our Convertible Debentures in our weighted-average dilutive shares outstanding because their effect would be anti-dilutive. For the nine months ended September 30, 2007, we have included 1,307 shares related to our Convertible Debentures in our diluted weighted-average common shares outstanding. We have not included the offset from the bond hedge in the weighted-average diluted common shares outstanding as it would be anti-dilutive. To the extent the Convertible Debentures are converted during the term of the bond hedge, the diluted share amount will decrease because the bond hedge will mitigate the dilution from conversion of the Convertible Debentures.

**(2) Operating Segment Information**

We operate in three segments. Our Printed Products Group provides lotteries with instant ticket and related services that include 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 licensed brand products and manufactures prepaid phone cards for cellular phone service providers. Our Lottery Systems Group offers online, instant and video lottery products and online and instant ticket validation systems. This division also provides 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. Our Diversified Gaming Group provides services and systems to private and public operators in the wide area gaming markets and the pari-mutuel wagering industry. The product offerings of the Diversified Gaming Group include server-based gaming machines (including our Nevada dual screen terminals, which can offer Great Britain regulated Category B2 or B3 content on the same machines), video lottery terminals ( VLTs ), monitor games, wagering systems for the pari-mutuel racing industry, sports betting systems and services, and Great Britain regulated Category C Amusement With Prize ( AWP ) and Skill With Prize ( SWP ) terminals. This division also includes our pari-mutuel gaming operations in Connecticut, Maine and the Netherlands.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(2) Operating Segment Information (continued)**

The following tables represent revenues, profits, depreciation, amortization and selling, general and administrative expenses for the three and nine month periods ended September 30, 2008 and 2007, by reportable segments. Corporate expenses, including interest expense, other income, and depreciation and amortization, are not allocated to the reportable segments.

	<b>Three Months Ended September 30, 2008</b>			
	<b>Printed Products Group</b>	<b>Lottery Systems Group</b>	<b>Diversified Gaming Group</b>	<b>Totals</b>
Service revenues	\$ 147,142	62,354	55,934	265,430
Sales revenues	7,431	15,072	4,002	26,505
Total revenues	154,573	77,426	59,936	291,935
Cost of services (exclusive of depreciation and amortization)	91,459	32,597	33,424	157,480
Cost of sales (exclusive of depreciation and amortization)	4,423	11,581	1,253	17,257
Selling, general and administrative expenses	14,330	6,860	5,449	26,639
Depreciation and amortization	9,276	15,409	11,519	36,204
Segment operating income	\$ 35,085	10,979	8,291	54,355
Unallocated corporate costs				\$ 15,581
Consolidated operating income				\$ 38,774

	<b>Three Months Ended September 30, 2007</b>			
	<b>Printed Products Group</b>	<b>Lottery Systems Group</b>	<b>Diversified Gaming Group</b>	<b>Totals</b>
Service revenues	\$ 139,132	54,583	50,811	244,526
Sales revenues	9,378	8,429	4,567	22,374
Total revenues	148,510	63,012	55,378	266,900
Cost of services (exclusive of depreciation and amortization)	82,399	28,867	30,669	141,935
Cost of sales (exclusive of depreciation and amortization)	7,805	3,809	4,260	15,874
Selling, general and administrative expenses	16,541	8,606	4,846	29,993
Depreciation and amortization	37,013	16,130	7,893	61,036
Segment operating income	\$ 4,752	5,600	7,710	18,062

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Unallocated corporate costs							\$	13,975
Consolidated operating income							\$	4,087

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited, in thousands, except per share amounts)

**(2) Operating Segment Information (continued)**

	<b>Nine Months Ended September 30, 2008</b>			
	<b>Printed Products Group</b>	<b>Lottery Systems Group</b>	<b>Diversified Gaming Group</b>	<b>Totals</b>
Service revenues	\$ 421,153	178,332	164,559	764,044
Sales revenues	24,648	47,335	18,884	90,867
Total revenues	445,801	225,667	183,443	854,911
Cost of services (exclusive of depreciation and amortization)	249,650	92,429	98,315	440,394
Cost of sales (exclusive of depreciation and amortization)	16,309	38,352	9,147	63,808
Selling, general and administrative expenses	47,860	25,742	19,493	93,095
Depreciation and amortization	28,728	45,765	30,774	105,267
Segment operating income	\$ 103,254	23,379	25,714	152,347
Unallocated corporate costs				\$ 48,512
Consolidated operating income				\$ 103,835

	<b>Nine Months Ended September 30, 2007</b>			
	<b>Printed Products Group</b>	<b>Lottery Systems Group</b>	<b>Diversified Gaming Group</b>	<b>Totals</b>
Service revenues	\$ 370,714	161,726	157,740	690,180
Sales revenues	28,734	29,944	29,885	88,563
Total revenues	399,448	191,670	187,625	778,743
Cost of services (exclusive of depreciation and amortization)	208,929	86,335	93,116	388,380
Cost of sales (exclusive of depreciation and amortization)	23,809	15,935	25,071	64,815
Selling, general and administrative expenses	43,746	23,941	15,408	83,095
Depreciation and amortization	55,536	45,486	20,894	121,916
Segment operating income	\$ 67,428	19,973	33,136	120,537
Unallocated corporate costs				\$ 40,967
Consolidated operating income				\$ 79,570

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(2) Operating Segment Information (continued)**

The following table provides a reconciliation of segment operating income to the consolidated income before income taxes for each period:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Reported segment operating income	\$ 54,355	\$ 18,062	\$ 152,347	\$ 120,537
Unallocated corporate costs	(15,581)	(13,975)	(48,512)	(40,967)
Consolidated operating income	38,774	4,087	103,835	79,570
Interest expense	(17,659)	(15,975)	(45,962)	(43,141)
Equity in earnings of joint ventures	13,356	8,344	48,612	31,623
Early extinguishment of long-term debt			(2,960)	
Other income	818	123	1,513	166
Income (loss) before income tax expense	\$ 35,289	\$ (3,421)	\$ 105,038	\$ 68,218

In evaluating financial performance, we focus on operating income as a segment's measure of profit or loss. Operating income is income before interest income, interest expense, equity in earnings of joint ventures, corporate expenses and income taxes. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies (see Note 1 of our Notes to Consolidated Financial Statements in our 2007 Annual Report on Form 10-K).

**(3) Equity Investments in Joint Ventures**

We are a member of Consorzio Lotterie Nazionali ( CLN ), a consortium consisting principally of the Company, Lottomatica S.p.A, and Arianna 2001, a company owned by the Federation of Italian Tobacconists. The consortium has a signed contract with the Italian Monopoli di Stato to be the exclusive operator of the Italian Gratta e Vinci instant lottery. The contract commenced in 2004 and has an initial term of six years with a six year extension option. Under our contract with the consortium, we supply instant lottery tickets, game development services, marketing support, and the instant ticket management system and systems support. We also participate in the profits or losses of the consortium as a 20% equity owner, and assist Lottomatica S.p.A in the lottery operations. We account for this investment using the equity method of accounting. For the three and nine months ended September 30, 2008, we recorded income of \$12,015 and \$42,977, respectively, representing our share of the earnings of the consortium for the indicated periods. For the three and nine months ended September 30, 2007, we recorded income of \$7,345 and \$29,315, respectively, representing our share of the earnings of the consortium for the indicated periods.





Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(4) Comprehensive Income**

The following presents a reconciliation of net income to comprehensive income for the three and nine month periods ended September 30, 2008 and 2007:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income (loss)	\$ 25,410	\$ (2,878)	\$ 74,313	\$ 48,988
Other comprehensive income (loss)				
Foreign currency translation gain (loss)	(40,808)	17,994	(22,180)	30,012
Unrealized gain (loss) on investments		831	(181)	1,197
Other comprehensive income (loss)	(40,808)	18,825	(22,361)	31,209
Comprehensive income (loss)	\$ (15,398)	\$ 15,947	\$ 51,952	\$ 80,197

**(5) Inventories**

Inventories consist of the following:

	September 30, 2008	December 31, 2007
Parts and work-in-process	\$ 49,580	\$ 48,167
Finished goods	42,106	44,398
	\$ 91,686	\$ 92,565

Point of sale terminals we manufacture may be sold to customers or included as part of long-term wagering system contracts. Parts and work-in-process includes costs for equipment expected to be sold. Costs incurred for equipment associated with specific wagering system contracts not yet placed in service are classified as construction in progress in property and equipment and are not depreciated.

**(6) Long-Term Debt**

In June 2008, we entered into certain debt financing transactions structured to extend the average maturity of the Company's debt, create additional borrowing capacity and revise certain financial covenants to be more favorable to the Company. We and our 100%-owned subsidiary, Scientific Games International, Inc. ( SGI ), entered into a credit agreement, dated as of June 9, 2008 (the Credit Agreement ), among SGI, as borrower, the Company, as guarantor, and the several lenders from time to time parties thereto. The Credit Agreement replaces the Company's credit agreement, dated as of December 23, 2004, as amended and restated as of January 24, 2007 (the 2004 Credit Agreement ). All amounts outstanding under the 2004 Credit Agreement were paid on June 9, 2008, and the 2004 Credit Agreement was terminated. In addition, on June 11, 2008, SGI issued \$200,000 of 7.875% senior subordinated notes due 2016 (the 2008 Notes ). The 2008 Notes were issued pursuant to an indenture dated as of June 11, 2008 (the Indenture ) among SGI, as issuer, the Company, as a guarantor, the Company's subsidiary guarantors party thereto and the trustee. In connection with the Credit Agreement and the issuance of the 2008 Notes, an aggregate of \$13,004 was paid to certain financial institutions in the form of fees and initial purchasers' discounts.

Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(6) Long-Term Debt (continued)**

*Credit Agreement*

The Credit Agreement provides for a \$250,000 senior secured revolving credit facility (the Revolver ) and a \$550,000 senior secured term loan credit facility (the Term Loan ). Under the terms of the Credit Agreement, SGI has the ability, subject to certain terms and conditions, to request additional tranches of term loans or to request an increase in the commitments under the Revolver, or a combination thereof, in a maximum aggregate amount of \$200,000 at a later date.

Amounts under the Revolver may be borrowed, repaid and reborrowed by SGI from time to time until maturity. The Credit Agreement will terminate on June 9, 2013, provided that the Revolver and the Term Loan will both mature on March 1, 2010 unless one of the following conditions is met:

- the right of holders of our Convertible Debentures to require the repurchase of their Convertible Debentures is eliminated;
- such Convertible Debentures are refinanced, redeemed or defeased (or a trust or escrow is established, on terms reasonably satisfactory to the administrative agent under the Credit Agreement, for purposes of and in an amount sufficient to discharge all payment obligations with respect to such Convertible Debentures); or
- the sum of the aggregate unused and available Revolver commitments under the Credit Agreement plus the unrestricted cash of SGI and the guarantors under the Credit Agreement is not less than the sum of the principal amount of such Convertible Debentures then outstanding plus \$50,000.

The Revolver and the Term Loan will both mature on September 15, 2012, unless one of the following conditions is met:

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

- our 6.25% Senior Subordinated Notes due 2012 (the 2004 Notes ) are refinanced, redeemed or defeased (or a trust or escrow is established, on terms and conditions reasonably satisfactory to the administrative agent under the Credit Agreement, for purposes of and in an amount sufficient to discharge such notes); or
- the sum of the aggregate unused and available Revolver commitments under the Credit Agreement plus the unrestricted cash of SGI and the guarantors under the Credit Agreement is not less than the sum of the principal amount of the 2004 Notes then outstanding plus \$50,000.

Voluntary prepayments and commitment reductions under the Credit Agreement are permitted at any time in whole or in part, without premium or penalty (other than breakfunding costs), upon proper notice and subject to a minimum dollar requirement.

Borrowings under the Credit Agreement bear interest at a rate per annum equal to, at SGI's option, either (1) a base rate determined by reference to the higher of (a) the prime rate of JPMorgan Chase Bank, N.A. and (b) the federal funds effective rate plus 0.50%, or (2) a reserve-adjusted LIBOR rate, in each case plus an applicable margin. The applicable margin varies based on the consolidated leverage ratio of the Company from 0.75% to 1.75% above the base rate for base rate loans, and 1.75% to 2.75% above LIBOR for LIBOR-based loans. From the date of the Credit Agreement to the filing date of this Quarterly Report, the applicable margins for base rate loans and LIBOR-based loans were 1.50% and 2.50%, respectively. During the term of the Credit Agreement, SGI will pay its lenders a fee equal to the product of 0.50% per annum and the unused portion of the Revolver.

We and our direct and indirect 100%-owned domestic subsidiaries (other than SGI) have provided a guarantee of the payment of SGI's obligations under the Credit Agreement. In addition, the obligations under the Credit Agreement are secured by a first priority, perfected lien on (1) substantially all the property and assets (real and personal, tangible and intangible) of the Company and its direct and indirect 100%-owned domestic subsidiaries and (2) 100% of our interest in the capital stock (or other equity interests) of all of our direct and indirect 100%-owned domestic subsidiaries and 65% of our interest in the capital stock (or other equity interests) of the first-tier foreign subsidiaries of SGI and the guarantors.

The Credit Agreement contains covenants customary for financings of this type, including negative covenants that, among other things, limit the ability of the Company and its subsidiaries to incur additional indebtedness, pay dividends or make distributions or certain other restricted payments, purchase or redeem capital stock, make investments or extend credit, engage in certain transactions with affiliates, engage in sale-leaseback transactions, consummate certain asset sales, effect a consolidation or merger, sell, transfer, lease or otherwise dispose of all or substantially all assets, or create certain liens and other encumbrances on assets. In addition, the Credit Agreement requires us to maintain the following financial ratios:

- a Consolidated Leverage Ratio as at the last day of a fiscal quarter not to exceed the ratio set forth below with respect to such fiscal quarter or with respect to the period during which such fiscal quarter ends:
- 4.25 to 1:00 (fiscal quarter ended June 30, 2008 through December 31, 2009)
- 4.00 to 1:00 (fiscal quarter ending March 31, 2010 and thereafter)



Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(6) Long-Term Debt (continued)**

Consolidated Leverage Ratio means, as of the last day of any period, the ratio of (1) Consolidated Total Debt (defined as the aggregate principal amount of our indebtedness, determined on a consolidated basis and required to be reflected on our balance sheet in accordance with Generally Accepted Accounting Principles ( GAAP )) on such day, to (2) Consolidated EBITDA for the period of four consecutive fiscal quarters then ended.

- a Consolidated Senior Debt Ratio as at the last day of a fiscal quarter not to exceed 2.50 to 1.00.

Consolidated Senior Debt Ratio means, as of the last day of any period, the ratio of (1) Consolidated Total Debt (other than the 2004 Notes, the 2008 Notes, the Convertible Debentures and any additional subordinated debt permitted under the Credit Agreement) to (2) Consolidated EBITDA for the period of four consecutive fiscal quarters then ended.

- a Consolidated Interest Coverage Ratio for any period of four consecutive fiscal quarters of at least 3.50 to 1.00 for any period of four consecutive fiscal quarters.

Consolidated Interest Coverage Ratio means, for any period, the ratio of (1) Consolidated EBITDA for such period to (2) total cash interest expense with respect to all outstanding indebtedness of the Company and its subsidiaries for such period.

For purposes of the foregoing, Consolidated EBITDA means, for any period, consolidated net income (or loss) of the Company and its subsidiaries for such period, determined in accordance with GAAP (excluding (a) the income (or deficit) of any entity accrued prior to the date it becomes a subsidiary of the Company or is merged into or consolidated with us or any of our subsidiaries, (b) the income (or deficit) of any entity (other than subsidiaries) in which we or our subsidiaries have an ownership interest, except to the extent such income is actually received by us or our subsidiaries through dividends or other distributions and (c) the undistributed earnings of any subsidiary (other than SGI) to the extent that the declaration or payment of dividends or similar distributions by such subsidiary is not at the time permitted by the terms of any contractual obligation (other than under the Credit Agreement or any related document) or requirement of law), plus, to the extent reflected as a charge in the statement of such consolidated net income for such period, the sum of (1) income tax expense, (2) interest expense, amortization or write-off of debt discount and debt issuance costs and commissions, discounts and other fees and charges associated with indebtedness, (3) depreciation and amortization expense, (4) amortization of intangibles (including goodwill) and organization costs, (5) certain earn-out payments, (6) extraordinary charges or losses determined in accordance with GAAP, (7) non-cash stock-based compensation expenses, (8) certain expenses, charges or losses resulting from certain investments in Peru not to exceed \$3,000 (9) the non-cash portion of any nonrecurring write-offs or write-downs as required in accordance with GAAP and (10) any advisory fees and related expenses in connection

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

with permitted acquisitions, and minus, to the extent included in the statement of such consolidated net income for such period, the sum of (i) interest income, (ii) any extraordinary income or gains determined in accordance with GAAP and (iii) any income or gains with respect to certain earn-out payments.

In addition, the Credit Agreement requires mandatory prepayments of the Term Loan with the net cash proceeds from (1) the incurrence of indebtedness by the Company or any of its subsidiaries (excluding certain permitted indebtedness) and (2) the sale of assets that yields net cash proceeds to the Company or any of its subsidiaries in excess of \$5,000 (excluding certain permitted sales of assets) or any settlement of or payment in respect of any property or casualty insurance claim or any condemnation proceeding relating to any asset of the Company of its subsidiaries, subject to a reinvestment exclusion.

We were in compliance with our covenants as of September 30, 2008.

As of September 30, 2008, we had approximately \$178,414 available for additional borrowing or letter of credit issuance under our Revolver. There were no borrowings and \$71,586 in outstanding letters of credit under our Revolver as of September 30, 2008. Our ability to borrow under the Credit Agreement will depend on us remaining in compliance with the limitations imposed by our lenders, including the maintenance of the foregoing financial ratios.

### *2008 Notes*

The 2008 Notes bear interest at the rate of 7.875% per annum, which accrues from June 11, 2008 and is payable semiannually in arrears on June 15 and December 15 of each year, commencing on December 15, 2008. The 2008 Notes mature on June 15, 2016, unless earlier redeemed or repurchased, and are subject to the terms and conditions set forth in the Indenture.



Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(6) Long-Term Debt (continued)**

SGI may redeem some or all of the 2008 Notes at any time prior to June 15, 2012 at a price equal to 100% of the principal amount of the 2008 Notes, plus accrued and unpaid interest, if any, to the date of redemption and a make whole premium calculated as set forth in the Notes. SGI may redeem some or all of the 2008 Notes for cash at any time on or after June 15, 2012 at redemption prices equal to 103.938%, 101.969% and 100% of the principal amount thereof if redeemed during the 12-month periods commencing on June 15 of 2012, 2013, and 2014 and thereafter, respectively, plus, in each case, accrued and unpaid interest, if any, to the date of redemption. In addition, at any time on or prior to June 15, 2011, SGI may redeem up to 35% of the initially outstanding aggregate principal amount of the 2008 Notes at a redemption price equal to 107.875% of the principal amount thereof, plus accrued and unpaid interest, if any, to the date of redemption, with the net cash proceeds contributed to the capital of SGI from one or more equity offerings of the Company. Additionally, if a holder of 2008 Notes is required to be licensed or found qualified under any applicable gaming laws or regulations and that holder does not become so licensed or found qualified or suitable, then SGI will have the right to, subject to certain notice provisions set forth in the Indenture, (1) require that holder to dispose of all or a portion of those 2008 Notes or (2) redeem the 2008 Notes of that holder at a redemption price calculated as set forth in the Notes.

Upon the occurrence of a change of control (as defined in the Indenture), SGI must make an offer to purchase the 2008 Notes at a purchase price equal to 101% of the principal amount thereof, plus accrued and unpaid interest, if any, to the date of repurchase. In addition, following an asset sale (as defined in the Indenture) and subject to the limitations contained in the Indenture, SGI must make an offer to purchase certain amounts of the 2008 Notes using the net cash proceeds from such asset sale to the extent such proceeds are not applied as set forth in the Indenture, at a purchase price equal to 100% of the principal amount of the 2008 Notes to be repurchased, plus accrued interest to the date of repurchase. SGI is not required to make any mandatory redemption or sinking fund payments with respect to the 2008 Notes.

The 2008 Notes are subordinated to all of SGI's existing and future senior debt, rank equally with all of SGI's existing and future senior subordinated debt, and rank senior to all of SGI's future debt that is expressly subordinated to the 2008 Notes. The 2008 Notes are guaranteed on a senior subordinated unsecured basis by the Company and all of our 100%-owned domestic subsidiaries (other than SGI). The guarantees of the 2008 Notes are subordinated to all of the guarantors' existing and future senior debt, rank equally with all of their existing and future senior subordinated debt, and rank senior to all of their future debt that is expressly subordinated to the guarantees of the 2008 Notes. The 2008 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The Indenture contains certain covenants that, among other things, limit the Company's ability, and the ability of certain of its subsidiaries, to incur additional indebtedness, pay dividends or make distributions or certain other restricted payments, purchase or redeem capital stock, make investments or extend credit, engage in certain transactions with affiliates, engage in sale-leaseback transactions, consummate certain asset sales, effect a consolidation or merger, or sell, transfer, lease or otherwise dispose of all or substantially all assets, or create certain liens and other encumbrances on assets.

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

The 2008 Notes were issued in a private offering to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933, as amended (the Securities Act ), and to persons outside the United States under Regulation S under the Securities Act. Under the terms of a registration rights agreement, we and SGI agreed, for the benefit of the holders of the 2008 Notes, to use our commercially reasonable efforts to file with the Securities and Exchange Commission (the SEC ) and cause to become effective a registration statement relating to an offer to exchange the 2008 Notes for an issue of SEC-registered notes (the Exchange Notes ) with terms identical to the 2008 Notes (except that the Exchange Notes will not be subject to restrictions on transfer or to any increase in annual interest rate as described below). If applicable interpretations of the staff of the SEC do not permit SGI to effect the exchange offer, SGI will use its commercially reasonable efforts to cause to become effective a shelf registration statement relating to resales of the 2008 Notes and to keep that shelf registration statement effective until the first anniversary of the date such shelf registration statement becomes effective, or such shorter period that will terminate when all 2008 Notes covered by the shelf registration statement have been sold. The obligation to complete the exchange offer and/or file a shelf registration statement will terminate on the second anniversary of the date of the registration rights agreement.

If the exchange offer is not completed (or, if applicable, the shelf registration statement is not declared effective) on or before March 11, 2009, the annual interest rate borne by the 2008 Notes will be increased by 0.25% per annum for the first 90-day period immediately following such date and by an additional 0.25% per annum with respect to each subsequent 90-day period, up to a maximum additional rate of 1.0% per annum thereafter until the exchange offer is completed, the shelf registration statement is declared effective or the obligation to complete the exchange offer and/or file the shelf registration statement terminates, at which time the interest rate will revert to the original interest rate on the date the 2008 Notes were originally issued.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(6) Long-Term Debt (continued)***Other Debt*

Our 2004 Notes in an aggregate principal amount of \$200,000 and our Convertible Debentures in an aggregate principal amount of \$273,782 remain outstanding. Please see our 2007 Annual Report on Form 10-K for descriptions of the 2004 Notes and the Convertible Debentures.

Short-term debt includes approximately \$47,596 of unsecured borrowings, denominated in Chinese Renminbi Yuan ( RMB ), from two banks in China. The borrowings have maturity dates of less than one year and interest rates ranging from 6.2% to 7.8%, which is 95% to 105% of the rate set by the People's Bank of China for similar type loans. The lending banks have received standby letters of credit issued under the Revolver to guarantee repayment of these borrowings. Proceeds from the borrowings are being used to procure and install our terminal validation network in China.

**(7) Goodwill and Intangible Assets**

The following disclosure presents certain information regarding our acquired intangible assets as of September 30, 2008 and December 31, 2007. Amortizable intangible assets are amortized over their estimated useful lives, as indicated below, with no estimated residual values.

<b>Intangible Assets</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Balance</b>
<b>Balance as of September 30, 2008</b>			
Amortizable intangible assets:			
Patents	\$ 11,050	(2,681)	8,369
Customer lists	30,903	(14,615)	16,288
Customer service contracts	4,088	(2,563)	1,525
Licenses	48,818	(32,317)	16,501
Intellectual property	20,584	(12,587)	7,997
Lottery contracts	28,091	(26,199)	1,892
	143,534	(90,962)	52,572
Non-amortizable intangible assets:			
Trade name	38,454	(2,118)	36,336
Connecticut off-track betting system operating right	35,609	(8,319)	27,290
	74,063	(10,437)	63,626

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Total intangible assets	\$	217,597	(101,399)	116,198
<b>Balance as of December 31, 2007</b>				
Amortizable intangible assets:				
Patents	\$	10,309	(2,135)	8,174
Customer lists		37,454	(17,164)	20,290
Customer service contracts		4,078	(2,358)	1,720
Licenses		45,603	(24,614)	20,989
Intellectual property		22,176	(9,542)	12,634
Lottery contracts		26,776	(20,756)	6,020
		146,396	(76,569)	69,827
Non-amortizable intangible assets:				
Trade name		38,981	(2,118)	36,863
Connecticut off-track betting system operating right		34,659	(8,319)	26,340
		73,640	(10,437)	63,203
Total intangible assets	\$	220,036	(87,006)	133,030

The aggregate intangible amortization expense for the three and nine months ended September 30, 2008 was approximately \$6,900 and \$21,800, respectively. The aggregate intangible amortization expense for the three and nine months ended September 30, 2007 was approximately \$19,800 and \$35,400, respectively.

Table of Contents

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

**(7) Goodwill and Intangible Assets (continued)**

The table below reconciles the change in the carrying amount of goodwill, by reporting segment, for the period from December 31, 2007 to September 30, 2008. In 2008, we recorded (a) a \$2,208 increase in goodwill associated with the acquisition of Oberthur Gaming Technologies and related companies ( OGT ), (b) a \$115 increase in goodwill associated with the acquisition of Games Media Limited, and (c) a decrease in goodwill of \$17,147 as a result of foreign currency translation.

Goodwill	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Balance as of December 31, 2007	\$ 328,719	194,519	193,618	716,856
Adjustments	501	456	(15,781)	(14,824)
Balance as of September 30, 2008	\$ 329,220	194,975	177,837	702,032

**(8) Pension and Other Post-Retirement Plans**

We have defined benefit pension plans for our union employees based in the U.S. and the U.K. (the U.S. Plan and the U.K. Plan ). In addition, with the acquisition of OGT, we have a pension plan for certain Canadian-based employees (the Canadian Plan ). Retirement benefits under the U.S. Plan are based upon the number of years of credited service up to a maximum of 30 years for the majority of the employees. Retirement benefits under the U.K. Plan are based on an employee's average compensation over the two years preceding retirement. Retirement benefits under the Canadian Plan are generally based on the number of years of credited service. Our policy is to fund the minimum contribution permissible by the respective tax authorities.

The following table sets forth the combined amount of net periodic benefit cost recognized for three and nine months ended September 30, 2008 and 2007.

Components of net periodic pension benefit cost:	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Service cost	\$ 713	\$ 798	\$ 2,138	\$ 1,964
Interest cost	1,366	1,225	4,099	3,079
Expected return on plan assets	(1,440)	(1,393)	(4,321)	(3,487)
Amortization of actuarial gains/losses	280	252	840	758

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Amortization of prior service costs		11		11		32		32
Net periodic cost	\$	930	\$	893	\$	2,788	\$	2,346

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(9) Income Taxes**

The effective tax rates of 28.0% and 29.3%, respectively, for the three and nine months ended September 30, 2008 were determined using an estimated annual effective tax rate, which was less than the federal statutory rate of 35% due to lower tax rates applicable to the increase in our earnings from operations outside the United States and the tax benefit of the 2004 debt restructuring. The effective tax rates for the three and nine months ended September 30, 2007 of 15.9% and 28.2%, respectively, were determined using an estimated annual effective tax rate, which was less than the federal statutory rate of 35% due to lower tax rates applicable to the increase in our earnings from operations outside the United States and the tax benefit of the 2004 debt restructuring.

**(10) Stockholders Equity**

The following demonstrates the change in the number of shares of Class A common stock outstanding during the three months ended September 30, 2008 and during the fiscal year ended December 31, 2007:

	<b>Three Months Ended September 30, 2008</b>	<b>Twelve Months Ended December 31, 2007</b>
Shares outstanding as of beginning of period	92,757	91,628
Shares issued as part of equity-based compensation plans and the ESPP, net of restricted stock units surrendered for taxes	120	1,786
Other shares issued		10
Shares repurchased into treasury stock		(10)
Shares outstanding as of end of period	92,877	93,414

Table of Contents

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

**(11) Stock-Based Compensation**

As of September 30, 2008, we had approximately 2,377 shares available for grants of equity awards under our equity-based compensation plans, of which 1,340 shares were available for grants of restricted stock units ( RSUs ).

*Stock Options*

A summary of the changes in stock options outstanding under our equity-based compensation plans during 2008 is presented below:

	Number of Options	Weighted Average Remaining Contract Term (Years)	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value
Options outstanding as of December 31, 2007	6,132	6.1	\$ 20.13	\$ 81,575
Granted	1,065		21.84	
Exercised	(74)		9.32	871
Cancelled	(103)		26.56	
Options outstanding as of March 31, 2008	7,020	6.4	\$ 20.41	\$ 31,770
Granted	513		25.63	
Exercised	(132)		15.96	2,082
Canceled	(8)		26.78	
Options outstanding as of June 30, 2008	7,393	6.5	\$ 20.85	\$ 70,143
Granted	137		29.82	
Exercised	(88)		14.75	1,426
Canceled	(10)		31.11	
Options outstanding as of September 30, 2008	7,432	6.3	\$ 21.07	\$ 36,795
Options exercisable as of September 30, 2008	3,576	4.4	\$ 15.82	\$ 32,753

The weighted-average grant date fair value of options granted during the three months ended September 30, 2008 was \$12.78. The weighted-average grant date fair value of options granted during the three months ended June 30, 2008 was \$12.58. The weighted-average grant date fair value of options granted during the three months ended March 31, 2008 was \$8.96. For the three and nine months ended September 30, 2008, we recognized equity-based compensation expense of approximately \$3,800 and \$11,300, respectively, related to the vesting of stock options and the related tax benefit of approximately \$1,100 and \$3,300, respectively. For the three and nine months ended September 30, 2007, we recognized equity-based compensation expense of approximately \$2,600 and \$8,700, respectively, related to the vesting of stock options and



Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

the related tax benefit of approximately \$400 and \$2,500, respectively. As of September 30, 2008, we had unearned compensation of approximately \$31,700 relating to stock option awards that will be amortized over a weighted-average period of approximately two years.

Table of Contents

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

**(11) Stock-Based Compensation (continued)***Restricted Stock Units*

A summary of the changes in RSUs outstanding under our equity-based compensation plans during 2008 is presented below:

	Number of Restricted Stock	Weighted Average Grant Date Fair Value Per Share
Non-vested units as of December 31, 2007	1,222	\$ 32.02
Granted	450	\$ 22.01
Vested	(127)	\$ 32.20
Cancelled	(22)	\$ 28.28
Non-vested units as of March 31, 2008	1,523	\$ 29.18
Granted	314	\$ 28.76
Vested	(36)	\$ 36.66
Canceled	(1)	\$ 24.60
Non-vested units as of June 30, 2008	1,800	\$ 28.97
Granted	42	\$ 29.99
Vested	(52)	\$ 30.63
Canceled	(3)	\$ 30.22
Non-vested units as of September 30, 2008	1,787	\$ 29.00

For the three and nine months ended September 30, 2008, we recognized equity-based compensation expense of approximately \$4,300 and \$12,900, respectively, related to the vesting of RSUs and the related tax benefit of approximately \$1,200 and \$3,800, respectively. For the three and nine months ended September 30, 2007, we recognized equity-based compensation expense of approximately \$3,700 and \$9,500, respectively, related to the vesting of RSUs and the related tax benefit of approximately \$500 and \$2,700, respectively. As of September 30, 2008, we had unearned compensation of approximately \$39,100 relating to RSUs that will be amortized over a weighted-average period of approximately two years.

**(12) Recently Issued Accounting Standards**

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

In May 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position ( FSP ) No. Accounting Principles Board ( APB ) 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Settlement)* ( FSP APB 14-1 ). FSP APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and must be applied retrospectively to all periods presented. We are currently evaluating the potential impact FSP APB 14-1 will have on our consolidated financial statements.

### (13) Subsequent Events

Effective October 17, 2008, SGI entered into a three-year interest rate swap agreement (the Hedge ) with JPMorgan Chase Bank N.A. ( JPMorgan ). Under the Hedge, SGI will pay interest on a \$100 million notional amount of debt at a fixed rate of 3.49% and will receive interest on a \$100 million notional amount of debt at the prevailing 3-month LIBOR rate. The objective of the Hedge is to eliminate the variability of cash flows attributable to the LIBOR component of interest expense paid on \$100 million of Scientific Games' variable-rate debt.

Mexico's Federal Competition Commission has launched an investigation into possible anti-competitive practices in the country's lottery market. Neither the Company nor its customer is a subject of this investigation. The investigation is focused on whether distribution agreements and other contracts provide a competitive advantage to one of the market participants. The Company anticipates a favorable outcome of this investigation that would create improved market conditions and positively affect profitability of the Company's lottery business in Mexico. In the absence of a positive effect, the Company might have to write-down some or all of the \$53 million USD capital invested in the lottery system there.

Table of Contents

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited, in thousands, except per share amounts)**

**(14) Financial Information for Guarantor Subsidiaries and Non-Guarantor Subsidiaries**

We conduct substantially all of our business through our domestic and foreign subsidiaries. SGI's obligations under the Credit Agreement and the 2008 Notes are fully and unconditionally and jointly and severally guaranteed by Scientific Games Corporation (the Parent Company) and our 100%-owned domestic subsidiaries other than SGI (the Guarantor Subsidiaries). Our 2004 Notes and our Convertible Debentures, which were issued by the Parent Company, are fully and unconditionally and jointly and severally guaranteed by our 100%-owned domestic subsidiaries, including SGI.

Presented below is condensed consolidating financial information for (i) the Parent Company, (ii) SGI, (iii) the 100%-owned Guarantor Subsidiaries other than SGI and (iv) the 100%-owned foreign subsidiaries and the non-100%-owned domestic and foreign subsidiaries (the Non-Guarantor Subsidiaries) as of September 30, 2008 and December 31, 2007 and for the three and nine months ended September 30, 2008 and 2007. The condensed consolidating financial information has been presented to show the nature of assets held, results of operations and cash flows of the Parent Company, SGI, the Guarantor Subsidiaries and the Non-Guarantor Subsidiaries assuming the guarantee structures of the Credit Agreement, the 2008 Notes, the Convertible Debentures and the 2004 Notes were in effect at the beginning of the periods presented.

The condensed consolidating financial information reflects the investments of the Parent Company in the Guarantor and Non-Guarantor Subsidiaries using the equity method of accounting. Corporate interest and administrative expenses have not been allocated to the subsidiaries.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET****September 30, 2008****(Unaudited, in thousands)**

	<b>Parent Company</b>	<b>SGI</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminating Entries</b>	<b>Consolidated</b>
<b>Assets</b>						
Cash and cash equivalents	\$ 95,798	208		71,586	(5,822)	161,770
Accounts receivable, net		104,977	57,946	78,314		241,237
Inventories		33,621	28,685	29,805	(425)	91,686
Other current assets	28,288	11,272	13,800	34,660		88,020
Property and equipment, net	5,579	186,690	129,735	308,566	(600)	629,970
Investment in subsidiaries	832,531	359,696	28,633		(1,220,860)	
Goodwill	6,526	273,194	67,926	354,386		702,032
Intangible assets		46,058	49,937	20,203		116,198
Intercompany balances	261,550		101,948		(363,498)	
Other assets	56,250	140,234	27,354	108,291	(6,101)	326,028
Total assets	\$ 1,286,522	1,155,950	505,964	1,005,811	(1,597,306)	2,356,941
<b>Liabilities and stockholders' equity</b>						
<b>Current installments of long-term debt</b>						
Current installments of long-term debt	\$	5,500		47,988		53,488
Current liabilities	39,608	55,454	47,613	82,511	(5,816)	219,370
<b>Long-term debt, excluding current installments</b>						
Long-term debt, excluding current installments	473,782	741,750		2,062		1,217,594
Other non-current liabilities	48,595	28,746	17,134	47,471	6	141,952
Intercompany balances		149,393		214,113	(363,506)	
Stockholders' equity	724,537	175,107	441,217	611,666	(1,227,990)	724,537
Total liabilities and stockholders' equity	\$ 1,286,522	1,155,950	505,964	1,005,811	(1,597,306)	2,356,941

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET****December 31, 2007****(Unaudited, in thousands)**

	<b>Parent Company</b>	<b>SGI</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminating Entries</b>	<b>Consolidated</b>
<b>Assets</b>						
Cash and cash equivalents	\$ 955	(119)	(268)	28,835		29,403
Accounts receivable, net		87,154	57,000	58,920		203,074
Inventories		45,717	20,187	27,086	(425)	92,565
Other current assets	30,940	8,193	6,345	27,357		72,835
Property and equipment, net	5,014	174,755	129,601	252,854	(600)	561,624
Investment in subsidiaries	724,263	308,079	2,264	214,825	(1,249,431)	
Goodwill	(162)	295,875	49,557	371,586		716,856
Intangible assets		49,878	53,995	29,157		133,030
Other assets	96,477	77,458	21,692	101,126	(6,101)	290,652
Total assets	\$ 857,487	1,046,990	340,373	1,111,746	(1,256,557)	2,100,039
<b>Liabilities and stockholders' equity</b>						
Current installments of long-term debt	\$ 4,500			442		4,942
Current liabilities	32,916	34,438	54,652	90,464	102	212,572
Long-term debt, excluding current installments	1,071,282			1,343		1,072,625
Other non-current liabilities	56,087	30,111	17,423	45,058	6	148,685
Intercompany balances	(968,513)	815,678	(57,647)	210,482		
Stockholders' equity	661,215	166,763	325,945	763,957	(1,256,665)	661,215
Total liabilities and stockholders' equity	\$ 857,487	1,046,990	340,373	1,111,746	(1,256,557)	2,100,039

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Three Months Ended September 30, 2008****(Unaudited, in thousands)**

	Parent Company	SGI	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	129,920	43,030	120,228	(1,243)	291,935
Cost of services and cost of sales (exclusive of depreciation and amortization)		77,857	29,770	68,338	(1,228)	174,737
Selling, general and administrative expenses	14,776	12,924	4,294	9,958	(15)	41,937
Depreciation and amortization	283	12,486	7,833	15,885		36,487
Operating income	(15,059)	26,653	1,133	26,047		38,774
Interest expense	4,632	12,082	10	935		17,659
Other income	(18,714)	24,099	(28,446)	8,887		(14,174)
Income (loss) before equity in income of subsidiaries, and income taxes	(977)	(9,528)	29,569	16,225		35,289
Equity in income (loss) of subsidiaries	26,047	27,516			(53,563)	
Income tax expense	(340)	6,527	116	3,576		9,879
Net income	\$ 25,410	11,461	29,453	12,649	(53,563)	25,410

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Three Months Ended September 30, 2007****(Unaudited, in thousands)**

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	108,453	63,209	96,107	(869)	266,900
Cost of services and cost of sales (exclusive of depreciation and amortization)		57,386	41,792	59,500	(869)	157,809
Selling, general and administrative expenses	702	14,482	17,952	10,602		43,738
Depreciation and amortization		15,601	7,109	38,556		61,266
Operating income	(702)	20,984	(3,644)	(12,551)		4,087
Interest expense	15,299	113	485	78		15,975
Other income	(745)	(7,809)	(242)	329		(8,467)

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Income (loss) before equity in income of subsidiaries, and income taxes	(15,256)	28,680	(3,887)	(12,958)		(3,421)
Equity in income (loss) of subsidiaries	11,861	(17,374)			5,513	
Income tax expense	(517)		51	(77)		(543)
Net income	\$ (2,878)	11,306	(3,938)	(12,881)	5,513	(2,878)



Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Nine Months Ended September 30, 2008****(Unaudited, in thousands)**

	<b>Parent Company</b>	<b>SGI</b>	<b>Guarantor Subsidiaries</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminating Entries</b>	<b>Consolidated</b>
Operating revenues	\$	386,155	121,816	350,167	(3,227)	854,911
Cost of services and cost of sales (exclusive of depreciation and amortization)		221,873	80,730	204,816	(3,217)	504,202
Selling, general and administrative expenses	45,884	45,196	12,675	37,070	(50)	140,775
Depreciation and amortization	832	38,160	23,608	43,499		106,099
Operating income	(46,716)	80,926	4,803	64,782	40	103,835
Interest expense	28,848	15,169	40	1,905		45,962
Other income	(31,525)	62,651	(85,429)	7,097	40	(47,165)
Income (loss) before equity in income of subsidiaries, and income taxes	(44,039)	3,106	90,192	55,779		105,038
Equity in income of subsidiaries	132,308	85,057			(217,365)	
Income tax expense	13,956	9,637	410	6,722		30,725
Net income	\$ 74,313	78,526	89,782	49,057	(217,365)	74,313

**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Nine Months Ended September 30, 2007****(Unaudited, in thousands)**

	<b>Parent Company</b>	<b>SGI</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminating Entries</b>	<b>Consolidated</b>
Operating revenues	\$	345,144	154,549	283,256	(4,206)	778,743
Cost of services and cost of sales (exclusive of depreciation and amortization)		176,681	100,672	179,931	(4,089)	453,195
Selling, general and administrative expenses	2,549	39,728	52,424	28,810	(133)	123,378
Depreciation and amortization		44,241	18,886	59,473		122,600
Operating income	(2,549)	84,494	(17,433)	15,042	16	79,570
Interest expense	41,841	508	572	220		43,141
Other income	1,401	(12,814)	(21,226)	834	16	(31,789)

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Income (loss) before equity in income of subsidiaries, and income taxes	(45,791)	96,800	3,221	13,988		68,218
Equity in income (loss) of subsidiaries	112,288	(19,294)			(92,994)	
Income tax expense	17,509	49	112	1,560		19,230
Net income	\$ 48,988	77,457	3,109	12,428	(92,994)	48,988

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS****Nine Months Ended September 30, 2008****(Unaudited, in thousands)**

	<b>Parent Company</b>	<b>SGI</b>	<b>Guarantor Subsidiaries</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminating Entries</b>	<b>Consolidated</b>
Net cash provided by operating activities	\$ (22,013)	(7,995)	125,704	56,118	(6,217)	145,597
<b>Cash flows from investing activities:</b>						
Capital and wagering systems expenditures	(690)	(32,490)	(13,385)	(87,800)		(134,365)
Business acquisitions, net of cash acquired			(2,980)	(194)		(3,174)
Other assets and investments	962	(4,769)	(38,004)	(15,365)	21,639	(35,537)
Net cash provided by (used in) investing activities	272	(37,259)	(54,369)	(103,359)	21,639	(173,076)
<b>Cash flows from financing activities:</b>						
Net proceeds (payments) on long-term debt	(602,000)	747,242		46,932		192,174
Net proceeds from stock issue	(5,309)	3,818	(2,319)	28,736	(21,906)	3,020
Purchase of treasury stock	(18,017)					(18,017)
Payment of financing fees		(15,085)				(15,085)
Other, principally intercompany balances	741,910	(690,392)	(68,748)	15,230	2,000	
Net cash provided by (used in) financing activities	116,584	45,583	(71,067)	90,898	(19,906)	162,092
Effect of exchange rate changes on cash				(907)	(1,339)	(2,246)
Increase (decrease) in cash and cash equivalents	94,843	329	268	42,750	(5,823)	132,367
Cash and cash equivalents, beginning of period	955	(119)	(268)	28,835		29,403
Cash and cash equivalents, end of period	\$ 95,798	210		71,585	(5,823)	161,770

Table of Contents

## SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

## SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Nine Months Ended September 30, 2007

(Unaudited, in thousands)

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Net cash provided by operating activities	\$ (24,214)	102,875	1,185	61,851	(105)	141,592
Cash flows from investing activities:						
Capital and wagering systems expenditures		(23,962)	(19,878)	(92,539)	22	(136,357)
Business acquisitions, net of cash acquired	(345)		(54,540)	(47,955)		(102,840)
Other assets and investments	(222,539)	113,810	(13,174)	(88,523)	156,086	(54,340)
Net cash provided by (used in) investing activities	(222,884)	89,848	(87,592)	(229,017)	156,108	(293,537)
Cash flows from financing activities:						
Net proceeds (payments) on long-term debt	151,625			(264)		151,361
Net proceeds from stock issue	11,701	(238,010)	135,443	258,650	(156,083)	11,701
Other, principally intercompany balances	83,772	41,469	(53,705)	(71,073)	(463)	
Net cash provided by (used in) financing activities	247,098	(196,541)	81,738	187,313	(156,546)	163,062
Effect of exchange rate changes on cash		18		1,603	543	2,164
Increase (decrease) in cash and cash equivalents		(3,800)	(4,669)	21,750		13,281
Cash and cash equivalents, beginning of period		(1,686)	5,758	23,719		27,791
Cash and cash equivalents, end of period	\$	(5,486)	1,089	45,469		41,072

Table of Contents

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

The following discussion addresses the results of operations of Scientific Games Corporation (together with its consolidated subsidiaries, we, us, our or the Company unless otherwise specified or the context otherwise requires), for the three and nine months ended September 30, 2008, compared to the corresponding periods in the prior year. This discussion should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations for the fiscal year ended December 31, 2007 included in our 2007 Annual Report on Form 10-K.

Our results may vary significantly from period to period depending on the addition or disposition of business units in each period. The acquisition of Oberthur Gaming Technologies and related companies ( OGT ) in May 2007 affects the comparability of operations for the nine month period ended September 30, 2008 and 2007.

The first and fourth quarters of the calendar year traditionally comprise the weakest season for our Diversified Gaming segment. As a result of inclement weather during the winter months, a number of racetracks do not operate and those that do operate often experience missed racing days. This adversely affects the amounts wagered and our corresponding service revenues. Additionally, the fourth quarter is the weakest quarter for Global Draw Limited ( Global Draw ) due to reduced wagering during the holiday season. Wagering and lottery equipment sales and software license revenues usually reflect a limited number of large transactions, which do not recur on an annual basis. Consequently, revenues and operating results of our Lottery Systems Group can vary substantially from period to period as a result of the timing of revenue recognition for major equipment sales and software licensing transactions and any Powerball jackpot activity in the quarter. In addition, Printed Products sales may vary depending on the season and timing of contract awards, changes in customer budgets, inventory ticket levels, lottery retail sales and general economic conditions.

**Background**



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

We operate primarily in three business segments: Printed Products Group, Lottery Systems Group and Diversified Gaming Group. Our revenues consist of two major components: services revenues and sales revenues.

### *Printed Products Group*

We provide instant tickets and related services. Instant ticket and related services include 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, including Major League Baseball®, National Basketball Association, Harley-Davidson®, Wheel-of-Fortune®, Hasbro®, Corvette®, World Poker Tour® and Deal or No Deal . This division also includes promotional instant tickets and pull-tab tickets that we sell to both lottery and non-lottery customers.

We are a worldwide manufacturer of prepaid phone cards, which entitle cellular phone users to a defined value of airtime. Prepaid phone cards offer consumers a cost-effective way to purchase cellular airtime, without requiring phone companies to extend credit or consumers to commit to contracts.

Prepaid phone cards utilize the secure process that we employ in the production of instant lottery tickets. This helps to ensure the integrity and reliability of the product, thus providing consumers in more than 50 countries with access to prepaid cellular phone service.

In the fourth quarter of 2007, we sold our interest in International Lotto Corp., SRL ( ILC ), which sale agreement was officially registered with a public notary in January 2008. In April 2008, the buyers of ILC informed us that they were voiding the sale agreement for certain specified reasons. We objected to their position and are now in arbitration in Peru with the buyers and are assessing our other legal rights and obligations.

### *Lottery Systems Group*

Our Lottery Systems business includes the supply of transaction processing software for the accounting and validation of instant ticket, online and video lottery games, point-of-sale terminal hardware sales, central site computers and communication hardware sales, and ongoing support and maintenance services for these products. This business also includes software and hardware and support services for sports betting and operation of credit card processing systems.

Mexico's Federal Competition Commission has launched an investigation into possible anti-competitive practices in the country's lottery market. Neither the Company nor its customer is a subject of this investigation. The investigation is focused on whether distribution agreements and other contracts provide a competitive advantage to one of the market participants. The Company anticipates a favorable outcome of this investigation that would create improved market conditions and positively affect profitability of the Company's lottery business in Mexico. In the absence of a positive effect, the Company might have to write-down some or all of the \$53 million USD capital invested in the lottery system there.

### *Diversified Gaming Group*

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

Our Diversified Gaming Group provides services and systems to private and public operators in the wide area gaming markets and in the pari-mutuel wagering industry. Our product offering includes server-based gaming machines (including our Nevada dual screen terminals, which can offer Great Britain regulated Category B2 or B3 content on the same machines), video lottery terminals ( VLTs ), monitor games, wagering systems for the pari-mutuel racing industry, sports betting systems and services and Great Britain



Table of Contents

regulated Category C Amusement With Prize ( AWP ) and Skill With Prize ( SWP ) terminals. Business units within the Diversified Gaming Group include: Global Draw, a leading supplier of gaming terminals, systems and monitor games to licensed bookmakers, primarily in the U.K., Austria and Mexico; Scientific Games Racing LLC, a leading worldwide supplier of computerized systems for pari-mutuel wagering; Games Media Limited ( Games Media ), our AWP and SWP terminal supplier in the U.K. public house (or pub) market; and our pari-mutuel gaming operations in Connecticut, Maine and the Netherlands.

**Results of Operations**

**Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007**

The following analysis compares the results of operations for the quarter ended September 30, 2008 to the results of operations for the quarter ended September 30, 2007.

*Overview*

*Revenue Analysis*

For the quarter ended September 30, 2008, total revenue was \$291.9 million compared to \$266.9 million for the quarter ended September 30, 2007, an increase of \$25.0 million or 9%. Our service revenue for the quarter ended September 30, 2008 was \$265.4 million compared to \$244.5 million for the quarter ended September 30, 2007, an increase of \$20.9 million, or 9%. The increase was primarily attributable to the sale of instant lottery tickets in China (\$12.8 million), increased revenue from instant ticket validation services in China (\$7.5 million) and increased revenue from Global Draw and Games Media. The increase was partially offset by decreased revenues from our licensed games (\$5.4 million) and the impact of the re-priced Pennsylvania cooperative services contract, which began impacting revenue during the third quarter 2007 (\$2.7 million). Our sales revenue for the quarter ended September 30, 2008 was \$26.5 million compared to \$22.4 million in the quarter ended September 30, 2007, an increase of \$4.1 million or 18%. The increase primarily reflects the sale of Wave terminals in Italy (\$4.5 million), the sale of video software upgrades in Quebec (\$1.7 million) and an up-front license of game software by Global Draw. The increase was partially offset by decreased sales in Germany, decreased phone card sales and decreased sales from Games Media reflecting the expected decline in sales of analog AWP terminals, as a result of the roll-out of digital AWP terminals, which are being deployed under revenue participation agreements.

*Expense Analysis*

Cost of services of \$157.5 million for the quarter ended September 30, 2008 was \$15.6 million or 11% higher than for the quarter ended September 30, 2007. The increase was primarily due to the sale of instant lottery tickets in China, including costs for air freight and duty on delivery of instant lottery tickets to China, costs associated with instant ticket validation services in China and costs associated with increased revenue from Global Draw, partially offset by lower costs associated with decreased revenues from our licensed games. Cost of sales of \$17.3 million for the quarter ended September 30, 2008 was \$1.4 million or 9% higher than the quarter ended September 30, 2007 primarily reflecting costs associated with the sale of Wave terminals in Italy and the sale of video software upgrades in Quebec, partially offset by reduced costs as a

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

result of the restructuring of our phone card manufacturing in the U.K., decreased sales in Germany and reduced sales from Games Media.

Selling, general and administrative expense of \$41.9 million for the quarter ended September 30, 2008 was \$1.8 million or 4% lower than for the quarter ended September 30, 2007. The decrease was primarily attributable to decreased legal, compliance and business development costs, reduced costs from OGT and reduced costs from ILC as a result of our disposal of the business in January 2008, partially offset by increased stock-based compensation costs.

Depreciation and amortization expense of \$36.5 million for the quarter ended September 30, 2008 decreased \$24.8 million or 40% from the same period in 2007, primarily due to asset impairment charges of \$26.1 million in the quarter ended September 30, 2007 for the impairment of long-lived assets in Peru and fixed assets in Germany as a result of our plan to rationalize our global Printed Products Group operations, partially offset by increased depreciation from Global Draw.

Interest expense of \$17.7 million for the quarter ended September 30, 2008 increased \$1.7 million or 11% from the same period in 2007, primarily attributable to increased borrowings, partially offset by a decline in interest rates.

Equity in earnings of joint ventures primarily reflects our share of the earnings from the Italian joint venture Consorzio Lotterie Nazionali ( CLN ) in connection with the operation of the Italian Gratta e Vinci instant lottery, our share of the equity of Roberts Communications Network, LLC ( RCN ) and our interest in Guard Libang. For the quarter ended September 30, 2008, our share of CLN 's income totaled \$12.0 million compared to \$7.3 million in the quarter ended September 30, 2007. The increase in income for the quarter ended September 30, 2008 reflects continued growth of instant ticket sales in Italy. For the quarter ended September 30, 2008, our share of the earnings of RCN was \$1.0 million and our share of the earnings of Guard Libang was \$0.5 million.

Income tax expense was \$9.9 million for the quarter ended September 30, 2008 versus an income tax benefit of \$0.5 million for

Table of Contents

the quarter ended September 30, 2007. The effective income tax rates for the quarters ended September 30, 2008 and 2007 were approximately 28.0% and 15.9% respectively. The increase in the effective income tax rate was primarily due to higher U.S. income taxes in the third quarter of 2008.

*Segment Overview*

*Printed Products*

For the quarter ended September 30, 2008, total revenue for Printed Products was \$154.6 million compared to \$148.5 million in the quarter ended September 30, 2007, an increase of \$6.1 million or 4%. For the quarter ended September 30, 2008, service revenue for Printed Products was \$147.1 million compared to \$139.1 million in the corresponding period in the prior year, an increase of \$8.0 million or 6%. The increase was primarily attributable to the sale of instant lottery tickets in China (\$12.8 million) and increased sales of instant lottery tickets in other venues, partially offset by decreased revenues from our licensed games (\$5.4 million) and from the impact of the re-priced Pennsylvania cooperative services contract, which began impacting revenue during the third quarter 2007 (\$2.7 million).

Printed Products sales revenue for the quarter ended September 30, 2008 was \$7.4 million compared to \$9.4 million for the quarter ended September 30, 2007, a decrease of \$2.0 million or 21%. The decrease was primarily the result of decreased sales in Germany and a decrease in phone card sales.

Cost of services of \$91.5 million for the quarter ended September 30, 2008 was \$9.1 million or 11% higher than from the same period in 2007. The increase was primarily due to the sale of instant lottery tickets in China, including costs for air freight and duty on delivery of instant lottery tickets to China, and costs resulting from increased sales of instant lottery tickets in other venues, partially offset by lower costs associated with decreased revenues from our licensed games.

Cost of sales of \$4.4 million for the quarter ended September 30, 2008 was \$3.4 million or 44% lower than for the quarter ended September 30, 2007 primarily due to reduced costs as a result of the restructuring of our phone card manufacturing in the U.K. and lower costs as a result of decreased sales in Germany.

Selling, general and administrative expense of \$14.3 million for the quarter ended September 30, 2008 was \$2.2 million or 13% lower than in the quarter ended September 30, 2007. The decrease was primarily due to reduced costs from OGT and reduced costs from ILC as a result of our disposal of the business in January 2008.

Depreciation and amortization expense of \$9.3 million for the quarter ended September 30, 2008 decreased \$27.7 million or 75% lower compared to the quarter ended September 30, 2007, primarily due to asset impairment charges of \$26.1 million in the quarter ended September 30, 2007 for the impairment of long-lived assets in Peru and fixed assets in Germany as a result of our plan to rationalize our global Printed Products Group operations.

*Lottery Systems*

For the quarter ended September 30, 2008, total revenue for Lottery Systems was \$77.4 million compared to \$63.0 million in the quarter ended September 30, 2007, an increase of \$14.4 million or 23%. Lottery Systems service revenue for the quarter ended September 30, 2008 was \$62.4 million compared to \$54.6 million for the quarter ended September 30, 2007, an increase of \$7.8 million or 14%. The increase was primarily due to increased revenue from instant ticket validation services in China (\$7.5 million) and increased revenues from Lottery Systems contracts in Europe, partially offset by a decrease in revenue from domestic contracts and reduced revenue from the absence of the Korea contract.

Lottery Systems sales revenue for the quarter ended September 30, 2008 was \$15.1 million compared to \$8.4 million for the quarter ended September 30, 2007, an increase of \$6.7 million. The increase was primarily due to the sale of Wave terminals in Italy (\$4.5 million), the sale of video software upgrades in Quebec (\$1.7 million), the sale of instant ticket vending machines in Pennsylvania and the sale of hardware in Hungary.

Cost of services of \$32.6 million for the quarter ended September 30, 2008 was \$3.7 million or 13% higher than in the quarter ended September 30, 2007. The increase was primarily due to costs associated with instant ticket validation services in China, higher costs on new domestic contracts and costs associated with increased revenues from Lottery Systems contracts in Europe.

Cost of sales of \$11.6 million for the quarter ended September 30, 2008 was \$7.8 million higher than for the quarter ended September 30, 2007, primarily due to costs associated with the sale of Wave terminals in Italy, the sale of video software upgrades in Quebec, the sale of instant ticket vending machines in Pennsylvania and the sale of hardware in Hungary.

Selling, general and administrative expense of \$6.9 million for the quarter ended September 30, 2008 was \$1.7 million or 20% lower than in the quarter ended September 30, 2007. The decrease was primarily attributable to decreased legal, compliance and

Table of Contents

business development costs, partially offset by increased stock-based compensation expense.

Depreciation and amortization expense of \$15.4 million for the quarter ended September 30, 2008 decreased \$0.7 million or 4% as compared to the quarter ended September 30, 2007, primarily due to decreased depreciation due to the absence of the Korea contract.

*Diversified Gaming*

For the quarter ended September 30, 2008, total revenue for Diversified Gaming was \$59.9 million compared to \$55.4 million in the quarter ended September 30, 2007, an increase of \$4.5 million or 8%. Diversified Gaming service revenue for the three months ended September 30, 2008 was \$55.9 million compared to \$50.8 million for the quarter ended September 30, 2007, an increase of \$5.1 million or 10%. The increase in service revenue primarily reflects increased revenue from Global Draw and Games Media, partially offset by lower revenue on our pari-mutuel contract in Germany as a result of changing to a fixed fee revenue structure and decreased revenue from our venue management business due to lower dollars wagered, or handle.

The Diversified Gaming sales revenue for the quarter ended September 30, 2008 was \$4.0 million compared to \$4.6 million in the same quarter in the prior year, a decrease of \$0.6 million or 13%. The decrease was primarily due to decreased sales from Games Media reflecting the expected decline in sales of analog AWP terminals, as a result of the roll-out of digital AWP terminals, which are being deployed under revenue participation agreements. The decrease was partially offset by an up-front license of game software by Global Draw.

Cost of services of \$33.4 million for the quarter ended September 30, 2008 was \$2.7 million or 9% higher than for the quarter ended September 30, 2007. The increase was primarily due to costs associated with increased revenue from Global Draw and increased costs associated with our domestic pari-mutuel business. The increase was partially offset by reduced costs from our venue management business.

Cost of sales of \$1.3 million for the quarter ended September 30, 2008 was \$3.0 million or 70% lower than for the quarter ended September 30, 2007, due to reduced sales from Games Media.

Selling, general and administrative expense of \$5.4 million for the quarter ended September 30, 2008 was \$0.6 million or 13% higher than for the quarter ended September 30, 2007. The increase was primarily due to increased costs from Games Media.

Depreciation and amortization expense of \$11.5 million for the quarter ended September 30, 2008 increased \$3.6 million or 46% from the quarter ended September 30, 2007, primarily due to increased depreciation from Global Draw and Games Media plus increased depreciation from our domestic pari-mutuel business.

**Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007**

The following analysis compares the results of operations for the nine months ended September 30, 2008 to the results of operations for the nine months ended September 30, 2007.

*Overview*

*Revenue Analysis*

For the nine months ended September 30, 2008, total revenue was \$854.9 million compared to \$778.7 million for the nine months ended September 30, 2007, an increase of \$76.2 million or 10%. Our service revenue for the nine months ended September 30, 2008 was \$764.0 million compared to \$690.2 million for the nine months ended September 30, 2007, an increase of \$73.8 million, or 11%. The increase was primarily attributable to an additional four months of service revenue from OGT, which was acquired in May 2007 (\$30.7 million), the launch of instant lottery tickets in China (\$25.6 million), revenue from instant ticket validation services in China (\$13.9 million) and increased revenue from Global Draw and Games Media. The increase was partially offset by the impact of the re-priced Pennsylvania cooperative services contract, which began impacting revenue during the third quarter 2007 (\$12.3 million) and decreased revenues from our licensed games (\$6.2 million). Our sales revenue for the nine months ended September 30, 2008 was \$90.9 million compared to \$88.6 million in the nine months ended September 30, 2007, an increase of \$2.3 million or 3%. The increase was primarily the result of the sale of Wave terminals in Italy (\$13.1 million), the sale of instant ticket vending machines in Pennsylvania, the sale of VLT hardware in West Virginia and an up-front license of game software by Global Draw. The increase was partially offset by decreased sales in Germany, a continuing decline in phone card prices and volumes reflecting a market shift to lower priced products and decreased sales from Games Media reflecting the expected decline in sales of analog AWP terminals as a result of the roll-out of digital AWP terminals, which are being deployed under revenue participation agreements.

Table of Contents

*Expense Analysis*

Cost of services of \$440.4 million for the nine months ended September 30, 2008 was \$52.0 million or 13% higher than for the nine months ended September 30, 2007. The increase was primarily related to an additional four months of costs from OGT which was acquired in May 2007, the launch of instant lottery tickets in China, including costs for air freight and duty on delivery of instant lottery tickets to China, costs associated with instant ticket validation services in China and costs associated with increased revenue from Global Draw. The increase was partially offset by reduced costs from ILC as a result of our disposal of the business in January 2008 and costs associated with decreased licensed games revenue.

Cost of sales of \$63.8 million for the nine months ended September 30, 2008 was \$1.0 million or 2% lower than the nine months ended September 30, 2007 primarily reflecting the decreased level of phone card sales, the decline of sales in Germany and reduced sales from Games Media, partially offset by costs associated with the sale of Wave terminals in Italy, the sale of instant ticket vending machines in Pennsylvania and the sale of VLT hardware in West Virginia.

Selling, general and administrative expense of \$140.8 million for the nine months ended September 30, 2008 was \$17.4 million or 14% higher than for the nine months ended September 30, 2007. The increase was primarily attributable to an additional four months of costs from OGT, which was acquired in May 2007, increased expense associated with the restructuring of phone card manufacturing in the U.K. (\$3.1 million), increased legal, compliance and business development costs, our expanded business in China, increased stock-based compensation costs and costs from the Global Draw earn-out (\$3.3 million). The increase was partially offset by reduced costs from ILC as a result of our disposal of the business in January 2008.

Depreciation and amortization expense of \$106.1 million for the nine months ended September 30, 2008 decreased \$16.5 million or 13% from the same period in 2007, primarily due to asset impairment charges of \$26.1 million in the quarter ended September 30, 2007 for the impairment of long-lived assets in Peru and fixed assets in Germany as a result of our plan to rationalize our global Printed Products Group operations, partially offset by increased depreciation from Global Draw and Games Media.

Interest expense of \$46.0 million for the nine months ended September 30, 2008 increased \$2.9 million or 7% from the same period in 2007, primarily attributable to increased borrowings, partially offset by a decline in interest rates.

Equity in earnings of joint ventures primarily reflects our share of the earnings from CLN in connection with the operation of the Italian Gratta e Vinci instant lottery, our share of the equity of RCN and our interest in Guard Libang. For the nine months ended September 30, 2008, our share of CLN's income totaled \$43.0 million compared to \$29.3 million in the nine months ended September 30, 2007. The increase in income for the nine months ended September 30, 2008 reflects continued growth of instant ticket sales in Italy. For the nine months ended September 30, 2008, our share of the earnings of RCN was \$2.9 million and our share of the earnings of Guard Libang was \$2.8 million.

Early extinguishment of long-term debt of \$3.0 million for the nine months ended September 30, 2008 reflects the write-off of unamortized deferred financing fees related to the Company's credit agreement, dated as of December 23, 2004, as amended and restated as of January 24, 2007 (the 2004 Credit Agreement), which was terminated and replaced with the credit agreement, dated as of June 9, 2008, among our 100%-owned subsidiary, Scientific Games International, Inc. (SGI), as borrower, the Company, as guarantor, and the several lenders from time

to time parties thereto (the Credit Agreement ).

Income tax expense was \$30.7 million for the nine months ended September 30, 2008 versus \$19.2 million for the nine months ended September 30, 2007. The effective income tax rates for the nine months ended September 30, 2008 and 2007 were approximately 29.3% and 28.2% respectively. The increase in the effective income tax rate was primarily due to higher U.S. income taxes in the first nine months of 2008.

#### *Segment Overview*

#### *Printed Products*

For the nine months ended September 30, 2008, total revenue for Printed Products was \$445.8 million compared to \$399.4 million in the nine months ended September 30, 2007, an increase of \$46.4 million or 12%. For the nine months ended September 30, 2008, service revenue for Printed Products was \$421.2 million compared to \$370.7 million for the nine months ended September 30, 2007, an increase of \$50.5 million or 14%. The increase was primarily attributable to an additional four months of service revenue from OGT, which was acquired in May 2007 (\$30.7 million), the launch of instant lottery tickets in China (\$25.6 million) and increased sales in Italy and other venues, partially offset by the impact of the re-priced Pennsylvania cooperative services contract, which began impacting revenue during the third quarter 2007 (\$12.3 million) and decreased revenues from our licensed games (\$6.2 million).

Printed Products sales revenue for the nine months ended September 30, 2008 was \$24.6 million compared to \$28.7 million for the nine months ended September 30, 2007, a decrease of \$4.1 million or 14%. The decrease was primarily the result of decreased sales in Germany and a continuing decline in phone card prices and volumes reflecting a market shift to lower priced products.



Table of Contents

Cost of services of \$249.7 million for the nine months ended September 30, 2008 was \$40.8 million or 20% higher than for the nine months ended September 30, 2007. The increase was primarily due to an additional four months of costs from OGT which was acquired in May 2007, the launch of instant lottery tickets in China, including costs for air freight and duty on delivery of instant lottery tickets to China, and increased sales of instant lottery tickets in Italy and other venues. The increase was partially offset by reduced costs from ILC as a result of our disposal of the business in January 2008 and decreased costs associated with decreased revenues from our licensed games.

Cost of sales of \$16.3 million for the nine months ended September 30, 2008 was \$7.5 million or 32% lower than for the nine months ended September 30, 2007 primarily due to the decreased level of phone card sales and the decline of sales in Germany.

Selling, general and administrative expense of \$47.9 million for the nine months ended September 30, 2008 was \$4.2 million or 10% higher than for the nine months ended September 30, 2007. The increase was primarily attributable to costs from OGT, which was acquired in May 2007, increased expense associated with the restructuring of phone card manufacturing in the U.K. (\$3.1 million), increased legal, compliance and business development costs, increased costs from our business in China and increased stock-based compensation costs. The increase was partially offset by reduced costs from ILC as a result of our disposal of the business in January 2008.

Depreciation and amortization expense of \$28.7 million for the nine months ended September 30, 2008 decreased \$26.8 million or 48% compared to the nine months ended September 30, 2007, primarily due to asset impairment charges of \$26.1 million in the quarter ended September 30, 2007 for the impairment of long-lived assets in Peru and fixed assets in Germany as a result of our plan to rationalize our global Printed Products Group operations.

*Lottery Systems*

For the nine months ended September 30, 2008, total revenue for Lottery Systems was \$225.7 million compared to \$191.7 million for the nine months ended September 30, 2007, an increase of \$34.0 million or 18%. Lottery Systems service revenue for the nine months ended September 30, 2008 was \$178.3 million compared to \$161.7 million for the nine months ended September 30, 2007, an increase of \$16.6 million or 10%. The increase was primarily due to increased revenue from instant ticket validation services in China (\$13.9 million) and increased revenue from our Lottery Systems contracts in Hungary and Puerto Rico. The increase was partially offset by a decrease in revenue from the South Carolina contract and a decrease in revenue from the absence of the Korea contract.

Lottery Systems sales revenue for the nine months ended September 30, 2008 was \$47.3 million compared to \$29.9 million for the nine months ended September 30, 2007, an increase of \$17.4 million or 58%. The increase was primarily due to the sale of Wave terminals in Italy (\$13.1 million), Lottery Systems sales in Germany and Norway, the sale of instant ticket vending machines in Pennsylvania and the sale of VLT hardware in West Virginia. The increase was partially offset by the absence of a one-time sale of ticket checker machines in Canada during the first nine months of 2007 and sales from the Korea contract.

Cost of services of \$92.4 million for the nine months ended September 30, 2008 was \$6.1 million or 7% higher than in the nine months ended September 30, 2007. The increase was primarily due to costs associated with instant ticket validation services in China, costs associated with revenue from our the Lottery Systems contract in Hungary, increased costs associated with the new online contract in Connecticut and increased costs on the Mexico contract. The increase was partially offset by a decrease in cost from the absence of the Korea contract.

Cost of sales of \$38.4 million for the nine months ended September 30, 2008 was \$22.5 million higher than in the nine months ended September 30, 2007, primarily due to costs associated with the sale of Wave terminals in Italy, Lottery Systems sales in Germany, the sale of instant ticket vending machines in Pennsylvania and the sale of VLT hardware in West Virginia. The increase was partially offset by a reduction in cost as a result of the absence of a one-time sale of instant ticket checker machines in Canada during the first nine months of 2007.

Selling, general and administrative expense of \$25.7 million for the nine months ended September 30, 2008 was \$1.8 million or 8% higher than for the nine months ended September 30, 2007. The increase was primarily attributable to increased legal, compliance and business development costs, our expanded business in China, and increased stock based-compensation costs.

Depreciation and amortization expense of \$45.8 million for the nine months ended September 30, 2008 increased \$0.3 million or 1% compared to the nine months ended September 30, 2007, primarily due to increased amortization of deferred installation costs for our Lottery Systems contract in Mexico, partially offset by reduced amortization due to the absence of the Korea contract.

#### *Diversified Gaming*

For the nine months ended September 30, 2008, total revenue for Diversified Gaming was \$183.4 million compared to \$187.6 million in the nine months ended September 30, 2007, a decrease of \$4.2 million or 2%. Diversified Gaming service revenue for the

Table of Contents

first nine months of 2008 was \$164.6 million compared to \$157.7 million for the nine months ended September 30, 2007, an increase of \$6.9 million or 4%. The increase in service revenue primarily reflects increased revenue from Global Draw and Games Media, partially offset by lower revenue on our pari-mutuel contract in Germany as a result of changing to a fixed fee revenue structure, lower revenue due to the loss of our Woodbine contract in Canada and decreased revenue from our venue management business due to lower handle.

The Diversified Gaming sales revenue for the nine months ended September 30, 2008 was \$18.9 million compared to \$29.9 million for the same nine months in the prior year, a decrease of \$11.0 million or 37%. The decrease was primarily due to decreased sales from Games Media reflecting the expected decline in sales of analog AWP terminals as a result of the roll-out of digital AWP terminals, which are being deployed under revenue participation agreements. The decrease was partially offset by an up-front license of game software by Global Draw.

Cost of services of \$98.3 million for the nine months ended September 30, 2008 was \$5.2 million or 6% higher than for the nine months ended September 30, 2007. The increase was primarily due to costs associated with increased revenue from Global Draw and increased costs associated with our domestic pari-mutuel business, partially offset by a decline in costs from our pari-mutuel contract in Germany as a result of changing to a fixed fee revenue structure, lower costs as a result of the loss of our Woodbine contract in Canada and lower costs from our venue management business.

Cost of sales of \$9.1 million for the nine months ended September 30, 2008 was \$16.0 million or 64% lower than for the nine months ended September 30, 2007, primarily due to reduced sales from Games Media.

Selling, general and administrative expense of \$19.5 million for the nine months ended September 30, 2008 was \$4.1 million or 27% higher than for the nine months ended September 30, 2007. The increase was primarily due to increased costs from the Global Draw earn-out (\$3.3 million) and increased costs from Games Media, partially offset by lower costs in our domestic pari-mutuel business and venue management business.

Depreciation and amortization expense of \$30.8 million for the nine months ended September 30, 2008 increased \$9.9 million or 47% primarily due to increased depreciation from Global Draw and Games Media plus increased depreciation from our domestic pari-mutuel business.

**Critical Accounting Policies**

There have been no material changes to our critical accounting policies from those discussed under the caption "Critical Accounting Policies" in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2007 Annual Report on Form 10-K.

**Liquidity, Capital Resources and Working Capital**

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

In June 2008, we entered into certain debt financing transactions structured to extend the average maturity of the Company's debt, create additional borrowing capacity and revise certain financial covenants to be more favorable to the Company. We and SGI entered into the Credit Agreement on June 9, 2008. The Credit Agreement replaces the Company's credit agreement, dated as of December 23, 2004, as amended and restated as of January 24, 2007 (the "2004 Credit Agreement"). All amounts outstanding under the 2004 Credit Agreement were paid on June 9, 2008, and the 2004 Credit Agreement was terminated. In addition, on June 11, 2008, SGI issued \$200,000 of 7.875% senior subordinated notes due 2016 (the "2008 Notes"). The 2008 Notes were issued pursuant to an indenture dated as of June 11, 2008 (the "Indenture") among SGI, as issuer, the Company, as a guarantor, the Company's subsidiary guarantors party thereto and the trustee. In connection with the Credit Agreement and the issuance of the 2008 Notes, an aggregate of \$13.0 million was paid to certain financial institutions in the form of fees and initial purchasers' discounts.

### *Credit Agreement*

The Credit Agreement provides for a \$250.0 million senior secured revolving credit facility (the "Revolver") and a \$550.0 million senior secured term loan credit facility (the "Term Loan"). Under the terms of the Credit Agreement, SGI has the ability, subject to certain terms and conditions, to request additional tranches of term loans or to request an increase in the commitments under the Revolver, or a combination thereof, in a maximum aggregate amount of \$200.0 million at a later date.

Amounts under the Revolver may be borrowed, repaid and reborrowed by SGI from time to time until maturity. The Credit Agreement will terminate on June 9, 2013, provided that the Revolver and the Term Loan will both mature on March 1, 2010 unless one of the following conditions is met:

- the right of holders of our 0.75% Convertible Senior Subordinated Debentures due 2024 (the "Convertible Debentures") to require the repurchase of their Convertible Debentures is eliminated;
- such Convertible Debentures are refinanced, redeemed or defeased (or a trust or escrow is established, on terms reasonably satisfactory to the administrative agent under the Credit Agreement, for purposes of and in an amount sufficient to discharge all payment obligations with respect to such Convertible Debentures); or

Table of Contents

- the sum of the aggregate unused and available Revolver commitments under the Credit Agreement plus the unrestricted cash of SGI and the guarantors under the Credit Agreement is not less than the sum of the principal amount of such Convertible Debentures then outstanding plus \$50.0 million.

The Revolver and the Term Loan will both mature on September 15, 2012, unless one of the following conditions is met:

- our 6.25% Senior Subordinated Notes due 2012 (the 2004 Notes ) are refinanced, redeemed or defeased (or a trust or escrow is established, on terms and conditions reasonably satisfactory to the administrative agent under the Credit Agreement, for purposes of and in an amount sufficient to discharge such notes); or
- the sum of the aggregate unused and available Revolver commitments under the Credit Agreement plus the unrestricted cash of SGI and the guarantors under the Credit Agreement is not less than the sum of the principal amount of the 2004 Notes then outstanding plus \$50.0 million.

Voluntary prepayments and commitment reductions under the Credit Agreement are permitted at any time in whole or in part, without premium or penalty (other than breakfunding costs), upon proper notice and subject to a minimum dollar requirement.

Borrowings under the Credit Agreement bear interest at a rate per annum equal to, at SGI's option, either (1) a base rate determined by reference to the higher of (a) the prime rate of JPMorgan Chase Bank, N.A. and (b) the federal funds effective rate plus 0.50%, or (2) a reserve-adjusted LIBOR rate, in each case plus an applicable margin. The applicable margin varies based on the consolidated leverage ratio of the Company from 0.75% to 1.75% above the base rate for base rate loans, and 1.75% to 2.75% above LIBOR for LIBOR-based loans. From the date of the Credit Agreement to the filing date of this Quarterly Report, the applicable margins for base rate loans and LIBOR-based loans were 1.50% and 2.50%, respectively. During the term of the Credit Agreement, SGI will pay its lenders a fee equal to the product of 0.50% per annum and the unused portion of the Revolver.

We and our direct and indirect 100%-owned domestic subsidiaries (other than SGI) have provided a guarantee of the payment of SGI's obligations under the Credit Agreement. In addition, the obligations under the Credit Agreement are secured by a first priority, perfected lien on (1) substantially all the property and assets (real and personal, tangible and intangible) of the Company and its direct and indirect 100%-owned domestic subsidiaries and (2) 100% of our interest in the capital stock (or other equity interests) of all of our direct and indirect 100%-owned domestic subsidiaries and 65% of our interest in the capital stock (or other equity interests) of the first-tier foreign subsidiaries of SGI and the guarantors.

The Credit Agreement contains covenants customary for financings of this type, including negative covenants that, among other things, limit the ability of the Company and its subsidiaries to incur additional indebtedness, pay dividends or make distributions or certain other restricted payments, purchase or redeem capital stock, make investments or extend credit, engage in certain transactions with affiliates, engage in sale-leaseback transactions, consummate certain asset sales, effect a consolidation or merger, sell, transfer, lease or otherwise dispose of all or substantially all assets, or create certain liens and other encumbrances on assets. In addition, the Credit Agreement requires us to maintain the

following financial ratios:

- a Consolidated Leverage Ratio as at the last day of a fiscal quarter not to exceed the ratio set forth below with respect to such fiscal quarter or with respect to the period during which such fiscal quarter ends:
- 4.25 to 1:00 (fiscal quarter ended June 30, 2008 through December 31, 2009)
- 4.00 to 1:00 (fiscal quarter ending March 31, 2010 and thereafter)

Table of Contents

Consolidated Leverage Ratio means, as of the last day of any period, the ratio of (1) Consolidated Total Debt (defined as the aggregate principal amount of our indebtedness, determined on a consolidated basis and required to be reflected on our balance sheet in accordance with Generally Accepted Accounting Principles ( GAAP )) on such day, to (2) Consolidated EBITDA for the period of four consecutive fiscal quarters then ended.

- a Consolidated Senior Debt Ratio as at the last day of a fiscal quarter not to exceed 2.50 to 1.00.

Consolidated Senior Debt Ratio means, as of the last day of any period, the ratio of (1) Consolidated Total Debt (other than the 2004 Notes, the 2008 Notes, the Convertible Debentures and any additional subordinated debt permitted under the Credit Agreement) to (2) Consolidated EBITDA for the period of four consecutive fiscal quarters then ended.

- a Consolidated Interest Coverage Ratio for any period of four consecutive fiscal quarters of at least 3.50 to 1.00 for any period of four consecutive fiscal quarters.

Consolidated Interest Coverage Ratio means, for any period, the ratio of (1) Consolidated EBITDA for such period to (2) total cash interest expense with respect to all outstanding indebtedness of the Company and its subsidiaries for such period.

For purposes of the foregoing, Consolidated EBITDA means, for any period, consolidated net income (or loss) of the Company and its subsidiaries for such period, determined in accordance with GAAP (excluding (a) the income (or deficit) of any entity accrued prior to the date it becomes a subsidiary of the Company or is merged into or consolidated with us or any of our subsidiaries, (b) the income (or deficit) of any entity (other than subsidiaries) in which we or our subsidiaries have an ownership interest, except to the extent such income is actually received by us or our subsidiaries through dividends or other distributions and (c) the undistributed earnings of any subsidiary (other than SGI) to the extent that the declaration or payment of dividends or similar distributions by such subsidiary is not at the time permitted by the terms of any contractual obligation (other than under the Credit Agreement or any related document) or requirement of law), plus, to the extent reflected as a charge in the statement of such consolidated net income for such period, the sum of (1) income tax expense, (2) interest expense, amortization or write-off of debt discount and debt issuance costs and commissions, discounts and other fees and charges associated with indebtedness, (3) depreciation and amortization expense, (4) amortization of intangibles (including goodwill) and organization costs, (5) certain earn-out payments, (6) extraordinary charges or losses determined in accordance with GAAP, (7) non-cash stock-based compensation expenses, (8) certain expenses, charges or losses resulting from certain investments in Peru not to exceed \$3,000 (9) the non-cash portion of any nonrecurring write-offs or write-downs as required in accordance with GAAP and (10) any advisory fees and related expenses in connection with permitted acquisitions, and minus, to the extent included in the statement of such consolidated net income for such period, the sum of (i) interest income, (ii) any extraordinary income or gains determined in accordance with GAAP and (iii) any income or gains with respect to certain earn-out payments.

In addition, the Credit Agreement requires mandatory prepayments of the Term Loan with the net cash proceeds from (1) the incurrence of indebtedness by the Company or any of its subsidiaries (excluding certain permitted indebtedness) and (2) the sale of assets that yields net cash proceeds to the Company or any of its subsidiaries in excess of \$5.0 million (excluding certain permitted sales of assets) or any settlement of or payment in respect of any property or casualty insurance claim or any condemnation proceeding relating to any asset of the Company of its subsidiaries, subject to a reinvestment exclusion.

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

We were in compliance with our covenants as of September 30, 2008.

As of September 30, 2008, we had approximately \$178.4 million available for additional borrowing or letter of credit issuance under our Revolver. There were no borrowings and \$71.6 million in outstanding letters of credit under our Revolver as of September 30, 2008. Our ability to borrow under the Credit Agreement will depend on us remaining in compliance with the limitations imposed by our lenders, including the maintenance of the foregoing financial ratios.

### *2008 Notes*

The 2008 Notes bear interest at the rate of 7.875% per annum, which accrues from June 11, 2008 and is payable semiannually in arrears on June 15 and December 15 of each year, commencing on December 15, 2008. The 2008 Notes mature on June 15, 2016, unless earlier redeemed or repurchased, and are subject to the terms and conditions set forth in the Indenture.



Table of Contents

SGI may redeem some or all of the 2008 Notes at any time prior to June 15, 2012 at a price equal to 100% of the principal amount of the 2008 Notes, plus accrued and unpaid interest, if any, to the date of redemption and a make whole premium calculated as set forth in the Notes. SGI may redeem some or all of the 2008 Notes for cash at any time on or after June 15, 2012 at redemption prices equal to 103.938%, 101.969% and 100% of the principal amount thereof if redeemed during the 12-month periods commencing on June 15 of 2012, 2013, and 2014 and thereafter, respectively, plus, in each case, accrued and unpaid interest, if any, to the date of redemption. In addition, at any time on or prior to June 15, 2011, SGI may redeem up to 35% of the initially outstanding aggregate principal amount of the 2008 Notes at a redemption price equal to 107.875% of the principal amount thereof, plus accrued and unpaid interest, if any, to the date of redemption, with the net cash proceeds contributed to the capital of SGI from one or more equity offerings of the Company. Additionally, if a holder of 2008 Notes is required to be licensed or found qualified under any applicable gaming laws or regulations and that holder does not become so licensed or found qualified or suitable, then SGI will have the right to, subject to certain notice provisions set forth in the Indenture, (1) require that holder to dispose of all or a portion of those 2008 Notes or (2) redeem the 2008 Notes of that holder at a redemption price calculated as set forth in the Notes.

Upon the occurrence of a change of control (as defined in the Indenture), SGI must make an offer to purchase the 2008 Notes at a purchase price equal to 101% of the principal amount thereof, plus accrued and unpaid interest, if any, to the date of repurchase. In addition, following an asset sale (as defined in the Indenture) and subject to the limitations contained in the Indenture, SGI must make an offer to purchase certain amounts of the 2008 Notes using the net cash proceeds from such asset sale to the extent such proceeds are not applied as set forth in the Indenture, at a purchase price equal to 100% of the principal amount of the 2008 Notes to be repurchased, plus accrued interest to the date of repurchase. SGI is not required to make any mandatory redemption or sinking fund payments with respect to the 2008 Notes.

The 2008 Notes are subordinated to all of SGI's existing and future senior debt, rank equally with all of SGI's existing and future senior subordinated debt, and rank senior to all of SGI's future debt that is expressly subordinated to the 2008 Notes. The 2008 Notes are guaranteed on a senior subordinated unsecured basis by the Company and all of our 100%-owned domestic subsidiaries (other than SGI). The guarantees of the 2008 Notes are subordinated to all of the guarantors' existing and future senior debt, rank equally with all of their existing and future senior subordinated debt, and rank senior to all of their future debt that is expressly subordinated to the guarantees of the 2008 Notes. The 2008 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The Indenture contains certain covenants that, among other things, limit the Company's ability, and the ability of certain of its subsidiaries, to incur additional indebtedness, pay dividends or make distributions or certain other restricted payments, purchase or redeem capital stock, make investments or extend credit, engage in certain transactions with affiliates, engage in sale-leaseback transactions, consummate certain asset sales, effect a consolidation or merger, or sell, transfer, lease or otherwise dispose of all or substantially all assets, or create certain liens and other encumbrances on assets.

The 2008 Notes were issued in a private offering to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933, as amended (the Securities Act), and to persons outside the United States under Regulation S under the Securities Act. Under the terms of a registration rights agreement, we and SGI agreed, for the benefit of the holders of the 2008 Notes, to use our commercially reasonable efforts to file with the Securities and Exchange Commission (the SEC) and cause to become effective a registration statement relating to an offer to exchange the 2008 Notes for an issue of SEC-registered notes (the Exchange Notes) with terms identical to the 2008 Notes (except that the Exchange Notes will not be subject to restrictions on transfer or to any increase in annual interest rate as described below). If applicable interpretations of the staff of the SEC do not permit SGI to effect the exchange offer, SGI will use its commercially reasonable efforts to cause to become effective a shelf registration statement relating to resales of the 2008 Notes and to keep that shelf registration statement effective until the first anniversary of the date such shelf registration statement becomes effective, or such shorter period that will terminate when all 2008 Notes covered by the shelf registration statement have been sold. The obligation to complete the exchange offer and/or file a shelf registration statement will terminate on the second anniversary of the date of the registration rights agreement.

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

If the exchange offer is not completed (or, if applicable, the shelf registration statement is not declared effective) on or before March 11, 2009, the annual interest rate borne by the 2008 Notes will be increased by 0.25% per annum for the first 90-day period immediately following such date and by an additional 0.25% per annum with respect to each subsequent 90-day period, up to a maximum additional rate of 1.0% per annum thereafter until the exchange offer is completed, the shelf registration statement is declared effective or the obligation to complete the exchange offer and/or file the shelf registration statement terminates, at which time the interest rate will revert to the original interest rate on the date the 2008 Notes were originally issued.

Table of Contents*Other Debt*

Our 2004 Notes in an aggregate principal amount of \$200.0 million and our Convertible Debentures in an aggregate principal amount of \$273.8 million remain outstanding. Please see our 2007 Annual Report on Form 10-K for descriptions of the 2004 Notes and the Convertible Debentures.

The terms of the indenture governing the Convertible Debentures give holders the right to convert the Convertible Debentures under certain circumstances, including when the market price of our common stock exceeds a specified target market price. The Convertible Debentures contain a net settlement feature. This feature entitles holders of each \$1,000 principal amount of Convertible Debentures being converted to receive cash up to \$1,000 and shares for any excess conversion value determined in a manner provided in the indenture governing the Convertible Debentures. We cannot offer any assurance that we will have sufficient available cash to pay for the Convertible Debentures presented to us for conversion nor can we offer any assurance that we will be able to refinance all or a portion of the converted Convertible Debentures at that time.

Short-term debt includes approximately \$47.6 million of unsecured borrowings, denominated in Chinese Renminbi Yuan ( RMB ), from two banks in China. The borrowings have maturity dates of less than one year and interest rates ranging from 6.2% to 7.8%, which is 95% to 105% of the rate set by the People's Bank of China for similar type loans. The lending banks have received standby letters of credit issued under the Revolver to guarantee repayment of these borrowings. Proceeds from the borrowings are being used to procure and install our terminal validation network in China.

Our contractual obligations and commercial commitments principally include obligations associated with our outstanding indebtedness and future minimum operating lease obligations, as set forth in the table below:

	Total	Cash Payments Due By Period			
		Within 1 Year	Within 2-3 Years	Within 4-5 Years	After 5 Years
Long-term debt, 6.25% notes	\$ 200,000			200,000	
Long-term debt, 0.75% notes (1)	273,782		273,782		
Long-term debt, 7.875% notes	200,000				200,000
Long-term debt, Term Loan	547,250	5,500	11,000	530,750	
Unsecured borrowings denominated in RMB	47,596	47,596			
Other long-term debt	2,454	392	1,428	73	561
Interest expense (2)	367,691	67,726	130,291	110,619	59,055
Global Draw earn out (4)	120,000	120,000			
Operating leases	87,748	19,815	29,006	19,923	19,004
Other long-term liabilities (3)	17,649	2,480	6,372	89	8,708
<b>Total contractual obligations</b>	<b>\$ 1,864,170</b>	<b>263,509</b>	<b>451,879</b>	<b>861,454</b>	<b>287,328</b>

- (1) The Convertible Debentures are due in 2024. However, these Convertible Debentures could require cash payment before that date if holders of these Convertible Debentures elect to convert the Convertible Debentures, subject to certain conditions, if we call the Convertible Debentures for redemption, or upon certain corporate transactions.
  
- (2) Based on rates in effect at September 30, 2008.
  
- (3) We have excluded approximately \$31.5 million of pension plan liabilities, deferred compensation liabilities of approximately \$20.8 million and the liability for uncertain tax positions of \$14.1 million at September 30, 2008. Due to the high degree of uncertainty regarding the timing of potential future cash flows associated with these liabilities, we are unable to make a reasonably reliable estimate of the amount and period in which these liabilities might be paid.
  
- (4) In accordance with the purchase agreement, we estimate that an earn-out of approximately \$120.0 million may be paid to the selling shareholders and certain members of the management of Global Draw in 2009.

Our pari-mutuel wagering and online lottery systems service contracts require us to, among other things, maintain the central computing system and related hardware in efficient working order, provide added software functionality upon request, provide on-site computer operators, and furnish necessary supplies. Our primary expenditures associated with these services are personnel and related costs, which are expensed as incurred and are included in Cost of Services in the consolidated statements of income. Historically, the revenues we derive from our pari-mutuel wagering and lottery systems service contracts have generally exceeded the direct costs associated with fulfilling our obligations thereunder. We expect that we will continue to realize positive cash flow and operating income as we extend or renew existing service contracts. We also expect that we will enter into new contracts that are accretive to our cash flow. In addition, through advancements in technology, we are continually deploying more efficient and cost effective methods for manufacturing and delivering our products and services to our customers. We expect that technological efficiencies will continue to positively impact our future cash flows and operating results. We are not party to any other material short-term or long-term obligations or commitments pursuant to these service contracts.

Table of Contents

Periodically, we bid on new pari-mutuel and online lottery contracts. Once awarded, these contracts generally require significant up-front capital expenditures for terminal assembly, customization of software, software and equipment installation and telecommunications configuration. Historically, we have funded these up-front costs through cash flows generated from operations, available cash on hand and borrowings under our credit facilities. Our ability to continue to procure new contracts will depend on, among other things, our then present liquidity levels and/or our ability to borrow at commercially acceptable rates to finance the initial up-front costs. Once operational, long-term service contracts have been accretive to our operating cash flow. The actual level of capital expenditures will ultimately largely depend on the extent to which we are successful in winning new contracts. Furthermore, our pari-mutuel wagering network consists of approximately 26,000 wagering terminals. Periodically, we elect to upgrade the technological capabilities of older terminals and replace terminals that have exhausted their useful lives. Servicing our installed terminal base requires that we maintain a supply of parts and accessories on hand. We are also required, contractually in some cases, to provide spare parts over an extended period of time, principally in connection with our systems and terminal sale transactions. To meet our contractual obligations and maintain sufficient levels of on-hand inventory to service our installed base, we purchase inventory on an as-needed basis. We presently have no inventory purchase obligations, other than in the ordinary course of business.

As of September 30, 2008, our available cash and borrowing capacity totaled \$340.2 million compared to \$150.6 million as of December 31, 2007. The amount of our available cash fluctuates principally based on the timing of collections from our customers, cash expenditures associated with new and existing online lottery systems service and pari-mutuel and fixed odds wagering contracts, borrowings or repayments under our credit facilities and changes in our working capital position.

The \$132.4 million increase in our available cash from the December 31, 2007 level principally reflects the net cash provided by operating activities for the nine months ended September 30, 2008 of \$145.6 million along with \$192.2 million of additional net borrowings, offset by wagering and other capital expenditures and other investing activities totaling \$168.1 million, acquisition related payments of \$3.2 million and the effects of exchange rates. The \$145.6 million of net cash provided by operating activities is derived from approximately \$192.7 million of net cash provided by operations, including a \$23.0 million cash dividend from CLN, offset by approximately \$47.1 million from changes in working capital. The working capital changes occurred principally from increases in accounts receivable and prepaids, deposits and other current assets, and decreases in other current liabilities, offset by increases in accrued liabilities and a decrease in inventory. Capital expenditures were \$10.9 million in the nine months ended September 30, 2008 compared to \$27.4 million in the corresponding period in 2007. Wagering system expenditures totaled \$123.5 million in the nine months ended September 30, 2008 compared to \$108.9 million in the corresponding period in 2007, and consisted primarily of our lottery contracts in Connecticut and server-based gaming terminals related to Global Draw's contracts with its customers. Other intangible assets and software expenditures during the three months ended September 30, 2008 consisted primarily of licensed properties, lottery contracts in Connecticut and gaming contracts related to Global Draw. Cash flow from financing activities principally reflects the borrowings under the Credit Agreement.

We believe that our cash flow from operations, available cash and available borrowing capacity under the Credit Agreement will be sufficient to meet our liquidity needs, including anticipated capital expenditures, for the foreseeable future; however, there can be no assurance that this will be the case. While we are not aware of any particular trends, our contracts periodically renew and there can be no assurance that we will be successful in sustaining our cash flow from operations through renewal of our existing contracts or through the addition of new contracts. In addition, lottery customers in the United States generally require service providers to provide performance bonds in connection with each state contract. Our ability to obtain performance bonds on commercially reasonable terms is subject to prevailing market conditions, which may be impacted by economic and political events. Although we have not experienced any difficulty in obtaining such bonds, there can be no assurance that we will continue to be able to obtain performance bonds on commercially reasonable terms or at all. If we need to refinance all or part of our indebtedness, on or before maturity, or provide letters of credit or cash in lieu of performance bonds, there can be no assurance that we will be able to obtain new financing or to refinance any of our indebtedness, on commercially reasonable terms or at all.

**Recently Issued Accounting Standards**

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

In May 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position ( FSP ) No. Accounting Principles Board ( APB ) 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Settlement)* ( FSP APB 14-1 ). FSP APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. Additionally, this FSP specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and must be applied retrospectively to all periods presented. We are currently evaluating the potential impact FSP APB 14-1 will have on our consolidated financial statements.

Table of Contents**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

In the normal course of business, we are exposed to fluctuations in interest rates and equity market risks as we seek debt and equity capital to sustain our operations. At September 30, 2008, approximately 53% of our debt was in fixed-rate instruments. The following table provides information about our financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted-average interest rates by expected maturity dates. (See Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity, Capital Resources and Working Capital for additional information about our financial instruments.)

Effective October 17, 2008, SGI entered into a three-year interest rate swap agreement (the Hedge) with JPMorgan Chase Bank N.A. (JPMorgan). Under the Hedge, SGI will pay interest on a \$100 million notional amount of debt at a fixed rate of 3.49% and will receive interest on a \$100 million notional amount of debt at the prevailing 3-month LIBOR rate. The objective of the Hedge is to eliminate the variability of cash flows attributable to the LIBOR component of interest expense paid on \$100 million of Scientific Games' variable-rate debt.

**Principal Amount by Expected Maturity    Average Interest Rate****September 30, 2008**

(Dollars in thousands)

	Twelve Months Ended December 31						Total	FMV
	2009	2010	2011	2012	2013	Thereafter		
Debt at fixed interest rates	\$ 392	146	1,282	42	200,031	474,343	676,236	640,171
Weighted-average interest rates	7.3%	4.4%	2.7%	5.4%	6.3%	3.8%	4.5%	
Debt at variable interest rates	\$ 53,096	5,500	5,500	5,500	525,250		594,846	592,110
Weighted-average interest rates	6.8%	6.3%	6.3%	6.3%	6.3%	0.0%	6.3%	

**Item 4. Controls and Procedures****Evaluation of Disclosure Controls and Procedures**

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. The evaluation was conducted under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in alerting management in a timely fashion to all material information required to be included in our periodic filings with the Securities and Exchange Commission.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



Table of Contents

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

On July 3, 2008, Scientific Games Racing, LLC ( SGR ), a wholly owned subsidiary of the Company that supplies tote systems to racetracks in California and elsewhere, finalized a settlement of a regulatory inquiry by the California Horse Racing Board (the CHRB ) into a software glitch affecting a type of wager known as Quick Pick offered on certain of SGR s pari-mutuel wagering terminals. As part of the settlement, SGR reimbursed the CHRB \$50,000 for the costs of its investigation and agreed to make a voluntary payment of \$150,000 to racing related charities.

Subsequently, two purported class actions relating to the Quick Pick wager were filed against Scientific Games Corporation, Scientific Games International, Inc. and Scientific Games Racing, LLC. Angel Romero filed one suit on behalf of himself and a class of similarly situated individuals in Superior Court of Los Angeles, Case No. BC-391885 (including claims against additional John Doe Defendants 1-20) on June 2, 2008. On August 5, 2008, Jerry Jamgotchian, individually and on behalf of all others similarly situated in California, Connecticut, Delaware, Indiana, Iowa, Louisiana, Maryland, Michigan, New York, New Jersey, Ohio, Pennsylvania, Texas or Wisconsin, brought a federal class action in the Central District of California, Case No. CV 08-05121 (including claims against additional John Doe Defendants 1-20). On October 22, 2008, the plaintiff in Romero moved to dismiss the state suit, which motion was granted on October 23, 2008. On October 22, 2008, the Court granted our Motion to Dismiss the federal case, without leave to refile.

**Item 1A. Risk Factors**

*We recognize significant earnings from our cooperative investment in CLN but we do not control distributions of its cash.*

We are a 20% equity owner in CLN, the income from which we account for under the equity method of accounting. Our investment in the consortium resulted in a significant portion of our income in 2007. For the year ended December 31, 2007, we recorded income of approximately \$37.7 million attributable to our interest in CLN. For the nine months ended September 30, 2008, we recorded income of approximately \$43.0 million attributable to our interest in CLN. Our investment in CLN is a minority investment and we do not control decisions relating to the distribution of its cash earnings. Lottomatica S.p.A., which owns one of our principal competitors, has a 63% interest in the consortium. If the consortium does not distribute earnings to equityholders we may record significant income attributable to our interest in the consortium but will not receive commensurate cash flow. Any inability to access cash earned by the consortium could adversely affect our ability to pay our debt obligations when they become due and payable.

*The holders of our Convertible Debentures have the right to require us to repurchase some or all of their Convertible Debentures in June 2010, and our 2004 Notes will mature in December 2012. The maturity of our credit facilities will be accelerated to March 2010 or September 2012, respectively, if certain conditions related to the Convertible Debentures or 2004 Notes, as applicable, are not satisfied.*

Under the terms of our Convertible Debentures, the holders of the Convertible Debentures may require us to repurchase some or all of their debentures for cash on June 1, 2010 at a repurchase price equal to 100% of the principal amount of the debentures being repurchased, plus

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

accrued and unpaid interest. In connection with that repurchase right, the terms of our Credit Agreement provide that the Term Loan and the Revolver will both mature on March 1, 2010, unless one of the following conditions is met:

- the right of holders of the Convertible Debentures to require the repurchase of their Convertible Debentures is eliminated;
- the Convertible Debentures are refinanced, redeemed or defeased (or a trust or escrow is established, on terms reasonably satisfactory to the administrative agent under the Credit Agreement, for purposes of and in an amount sufficient to discharge all payment obligations with respect to the Convertible Debentures); or
- the sum of the aggregate unused and available Revolver commitments plus our unrestricted cash is not less than the sum of the principal amount of Convertible Debentures then outstanding plus \$50 million.

Table of Contents

If none of these conditions is met as of December 31, 2009, the amount of indebtedness outstanding under the Term Loan and any amount outstanding under the Revolver may be classified as current debt on our balance sheet, which could lead to a going concern qualification from our independent auditors in their audit report on our 2009 consolidated financial statements. Under the terms of the Credit Agreement, delivery of an audit report containing a going concern qualification would, if not cured within 30 days, constitute an event of default and could, if not waived by the lenders, result in acceleration of all outstanding indebtedness under the Credit Agreement.

In addition, our 2004 Notes mature on December 15, 2012. In connection with the anticipated maturity of the 2004 Notes, the terms of our Credit Agreement provide that the Term Loan and Revolver will both mature on September 15, 2012, unless one of the following conditions is met:

- the 2004 Notes are refinanced, redeemed or defeased (or a trust or escrow is established, on terms and conditions reasonably satisfactory to the administrative agent, for purposes of and in an amount sufficient to discharge the 2004 Notes); or
- the sum of the aggregate unused and available Revolver commitments plus our unrestricted cash is not less than the sum of the principal amount of the 2004 Notes then outstanding plus \$50 million.

If none of these conditions is met as of December 31, 2011, the amount of indebtedness outstanding under the Term Loan and any amount outstanding under the Revolver may be classified as current debt on our balance sheet, which could lead to a going concern qualification from our independent auditors in their audit report on our 2011 consolidated financial statements. Under the terms of the Credit Agreement, delivery of an audit report containing a going concern qualification would, if not cured within 30 days, constitute an event of default and could, if not waived by the lenders, result in acceleration of all outstanding indebtedness under the Credit Agreement.

We cannot assure you that we will have sufficient financial resources, or will be able to arrange financing, to satisfy the conditions set forth above or to repay any accelerated indebtedness under our Credit Agreement or, even if we obtain a waiver from our lenders under our Credit Agreement, to repurchase the Convertible Debentures in 2010 or such later date as such repurchase may be required, or to repay the 2004 Notes in 2012.

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

**ISSUER PURCHASES OF EQUITY SECURITIES**

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (2)

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

7/1/2008 - 7/31/2008	15,403	\$	30.04	\$	172.1 million
8/1/2008 - 8/31/2008	4,376	\$	31.05	\$	172.1 million
9/1/2008 - 9/30/2008		\$		\$	172.1 million
Total	19,779	\$	30.26	\$	172.1 million

---

(1) The activity in this column reflects shares acquired from employees to satisfy the withholding taxes associated with the vesting of restricted stock units during the three months ended September 30, 2008.

(2) The stock repurchase program was originally publicly announced on November 2, 2006 and extended on December 13, 2007. Under the repurchase program, we are authorized to repurchase, from time to time in the open market through December 31, 2008, shares of our outstanding common stock in an aggregate amount up to \$200.0 million. Purchases are funded by cash flows from operations, borrowings, or a combination thereof. The timing and amount of purchases is determined by our management based on its evaluation of market conditions, share price and other factors, including limitations under the terms of certain of our debt agreements. The stock repurchase program may be suspended or discontinued at any time. There were no repurchases of common stock under the publicly announced stock repurchase program during the three months ended September 30, 2008.

Table of Contents

**Item 6. Exhibits**

**Exhibit**

**Number**

- 10.1 Letter Agreement dated August 5, 2008 between the Company and Steven M. Saferin, which amended the Employment Agreement dated as of January 1, 2006 by and between Scientific Games International, Inc. and Mr. Saferin (executed on August 2, 2006) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 8, 2008).
- 31.1 Certification of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 31.2 Certification of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 32.1 Certification of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )
- 32.2 Certification of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )

---

( ) Filed herewith.

Table of Contents

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SCIENTIFIC GAMES CORPORATION  
(Registrant)

By: /s/ DeWayne E. Laird  
Name: DeWayne E. Laird  
Title: Vice President and Chief Financial Officer  
(principal financial officer)

Dated: November 4, 2008

Table of Contents

**INDEX TO EXHIBITS**

**Exhibit  
Number**

- 10.1 Letter Agreement dated August 5, 2008 between the Company and Steven M. Saferin, which amended the Employment Agreement dated as of January 1, 2006 by and between Scientific Games International, Inc. and Mr. Saferin (executed on August 2, 2006) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 8, 2008).
- 31.1 Certification of the Chief Executive Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 31.2 Certification of the Chief Financial Officer of the Company pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934. ( )
- 32.1 Certification of the Chief Executive Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )
- 32.2 Certification of the Chief Financial Officer of the Company pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ( )

---

( ) Filed herewith.