

SCIENTIFIC GAMES CORP
Form 10-Q
May 12, 2008

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 March 31, 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

(State or other jurisdiction of
incorporation or organization)

81-0422894

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

750 Lexington Avenue, New York, New York 10022

(Address of principal executive offices)

(Zip Code)

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(212) 754-2233

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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
(Do not check if a smaller reporting company)

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 May 7, 2008:

Class A Common Stock: 92,614,278

Class B Common Stock: None

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

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THREE MONTHS ENDED MARCH 31, 2008

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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. 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.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

As of March 31, 2008 and December 31, 2007

(Unaudited, in thousands, except per share amounts)

PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

	March 31, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 31,924	\$ 29,403
Accounts receivable, net of allowance for doubtful accounts of \$9,443 and \$9,184 as of March 31, 2008 and December 31, 2007, respectively	198,936	203,074
Inventories	93,926	92,565
Deferred income taxes, current portion	16,172	15,929
Prepaid expenses, deposits and other current assets	62,831	56,906
Total current assets	403,789	397,877
Property and equipment, at cost	1,035,211	966,291
Less: accumulated depreciation	(439,117)	(404,667)
Net property and equipment	596,094	561,624
Goodwill, net	724,892	716,856
Intangible assets, net	129,103	133,030
Other assets and investments	312,654	290,652
Total assets	\$ 2,166,532	\$ 2,100,039
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current installments of long-term debt	\$ 13,777	\$ 4,942
Accounts payable	56,657	64,108
Accrued liabilities	146,494	148,464
Total current liabilities	216,928	217,514
Deferred income taxes	53,272	51,661
Other long-term liabilities	95,680	97,024
Long-term debt, excluding current installments	1,111,920	1,072,625
Total liabilities	1,477,800	1,438,824
Commitments and contingencies		
Stockholders equity:		
Class A common stock, par value \$0.01 per share, 199,300 shares authorized, and 92,581 and 93,414 shares outstanding as of March 31, 2008 and December 31, 2007, respectively	926	934
Additional paid-in capital	532,788	521,902
Accumulated earnings	117,230	97,323
Treasury stock, at cost, 2,140 and 1,140 shares held as of March 31, 2008 and December 31, 2007, respectively	(37,459)	(19,442)

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Accumulated other comprehensive income	75,247	60,498
Total stockholders' equity	688,732	661,215
Total liabilities and stockholders' equity	\$ 2,166,532	\$ 2,100,039

See accompanying notes to consolidated financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

Three Months Ended March 31, 2008 and 2007

(Unaudited, in thousands, except per share amounts)

	Three Months Ended March 31,	
	2008	2007
Operating revenues:		
Services	\$ 233,953	\$ 210,993
Sales	23,054	31,273
	257,007	242,266
Operating expenses:		
Cost of services (exclusive of depreciation and amortization)	130,378	116,747
Cost of sales (exclusive of depreciation and amortization)	16,844	22,485
Selling, general and administrative expenses	49,788	39,145
Depreciation and amortization	34,504	29,078
Operating income	25,493	34,811
Other (income) expense:		
Interest expense	13,884	12,892
Equity in income of joint ventures	(16,859)	(11,878)
Other (income) expense, net	50	(390)
	(2,925)	624
Income before income taxes	28,418	34,187
Income tax expense	8,511	9,428
Net income	\$ 19,907	\$ 24,759
Basic and diluted net income per share:		
Basic net income per share	\$ 0.21	\$ 0.27
Diluted net income per share	\$ 0.21	\$ 0.26
Weighted-average number of shares used in per share calculations:		
Basic shares	93,314	91,993
Diluted shares	94,718	95,288

See accompanying notes to consolidated financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Three months Ended March 31, 2008 and 2007

(Unaudited, in thousands, except per share amounts)

	Three Months Ended March 31,	
	2008	2007
Net cash provided by operating activities	\$ 38,430	\$ 30,420
Cash flows from investing activities:		
Capital expenditures	(3,680)	(2,465)
Wagering system expenditures	(49,315)	(23,543)
Other intangible assets and software expenditures	(11,031)	(8,354)
Change in other assets and liabilities, net	14	(6,447)
Business acquisitions, net of cash acquired	(2,742)	(336)
Net cash used in investing activities	(66,754)	(41,145)
Cash flows from financing activities:		
Net borrowings under revolving credit facility	40,500	(191,000)
Net proceeds of long-term debt	7,417	198,665
Purchase of treasury stock	(18,017)	
Net proceeds from issuance of common stock	(27)	8,360
Net cash provided by financing activities	29,873	16,025
Effect of exchange rate changes on cash and cash equivalents	972	140
Increase in cash and cash equivalents	2,521	5,440
Cash and cash equivalents, beginning of period	29,403	27,791
Cash and cash equivalents, end of period	\$ 31,924	\$ 33,231

See accompanying notes to consolidating financial statements.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

Notes to Consolidated Financial Statements

(1) Consolidated Financial Statements

Basis of Presentation

The consolidated balance sheet as of March 31, 2008, the consolidated statements of income for the three months ended March 31, 2008 and 2007, and the condensed consolidated statements of cash flows for the three months ended March 31, 2008 and 2007, have been prepared by Scientific Games Corporation and are unaudited. When used in these notes, the terms the Company, we, us, our and our Company mean 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 March 31, 2008 and the results of our operations and our cash flows for the three months ended March 31, 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 March 31, 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 months ended March 31, 2008 and 2007:

	Three Months Ended March 31,	
	2008	2007
Income (numerator)		
Net income	\$ 19,907	\$ 24,759
Shares (denominator)		
Weighted-average basic common shares outstanding	93,314	91,993
Effect of dilutive securities-stock rights	1,404	2,611
		684

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Effect of dilutive shares related to convertible debentures			
Weighted-average diluted common shares outstanding		94,718	95,288
Basic and diluted per share amounts			
Basic net income per share	\$	0.21	\$ 0.27
Diluted net income per share	\$	0.21	\$ 0.26

The weighted-average diluted common shares outstanding for the three months ended March 31, 2008 and 2007 excludes the effect of approximately 3,439 and 1,142, respectively, out-of-the-money stock options, because their effect would be anti-dilutive.

The aggregate number of shares that we could be obligated to issue upon conversion of the remaining \$273,800 in aggregate principal amount of 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.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(1) Consolidated Financial Statements (continued)

During the first quarter of 2008, the conversion price of the Convertible Debentures exceeded the average price of our common stock. Therefore, the weighted-average diluted common shares outstanding for the three months ended March 31, 2008 excludes the effect of shares that could be issued upon conversion of the Convertible Debentures because their effect would be anti-dilutive. During the first quarter of 2007, the average price of our common stock exceeded the conversion price of the Convertible Debentures. For the three months ended March 31, 2007 we have included approximately 684 shares related to our Convertible Debentures in our weighted-average diluted common shares outstanding. For the three months ended March 31, 2007, we did not include 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) Acquisitions

During the third quarter of 2007, we announced plans to close our instant ticket printing plant in San Antonio, Texas in conjunction with ongoing integration efforts related to our May 1, 2007 acquisition of Oberthur Gaming Technologies and related companies (OGT). We recorded approximately \$8,221 in liabilities, primarily related to involuntary employee terminations, asset disposals and termination of contractual obligations. The table below summarizes the balance of the accrued integration costs as of March 31, 2008:

		Severance Pay and Benefits	Asset Disposal Costs	Contractual Obligations	Total Liability
Accrued costs as of December 31, 2007	\$	517	865	3,889	5,271
Adjustments to liability		1,483			1,483
Payments		(1,461)	(7)	(911)	(2,379)
Accrued costs as of March 31, 2008	\$	539	858	2,978	4,375

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(2) Acquisitions (continued)

In conjunction with the purchase of substantially all of the online lottery assets of EssNet AB (EssNet) in March of 2006, we recorded approximately \$26,717 in liabilities, primarily related to involuntary employee terminations, termination of leases and termination of service contracts that will result from the integration. The table below summarizes the payments made and adjustments to the balance of the accrued integration costs from December 31, 2007 to March 31, 2008:

	Severance Pay and Benefits	Lease Terminations	Contractual Obligations	Total Liability
Accrued costs as of December 31, 2007	\$ 345	329	2,913	3,587
Payments	(115)	(313)	(227)	(655)
Foreign exchange rate adjustments	15	14	123	152
Accrued costs as of March 31, 2008	\$ 245	30	2,809	3,084

(3) Operating Segment Information

We operate in three segments. Our Printed Products Group provides lotteries with instant ticket and related services that includes ticket design and manufacturing as well as value-added services, including game design, sales and marketing support, inventory management and warehousing and fulfillment services. Additionally, this division provides lotteries with 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.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(3) Operating Segment Information (continued)

The following tables represent revenues, profits, depreciation, amortization and selling, general and administrative expenses for the three month periods ended March 31, 2008 and 2007, by current reportable segments. Corporate expenses, including interest expense, other income, and depreciation and amortization, are not allocated to the reportable segments.

	Three Months Ended March 31, 2008			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 127,226	54,646	52,081	233,953
Sales revenues	8,671	7,764	6,619	23,054
Total revenues	135,897	62,410	58,700	257,007
Cost of services (exclusive of depreciation and amortization)	70,813	28,649	30,916	130,378
Cost of sales (exclusive of depreciation and amortization)	6,245	5,872	4,727	16,844
Selling, general and administrative expenses	17,741	9,278	6,783	33,802
Depreciation and amortization	9,976	14,974	9,285	34,235
Segment operating income	\$ 31,122	3,637	6,989	41,748
Unallocated corporate costs				\$ 16,255
Consolidated operating income				\$ 25,493

	Three Months Ended March 31, 2007			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 104,631	54,331	52,031	210,993
Sales revenues	9,262	11,049	10,962	31,273
Total revenues	113,893	65,380	62,993	242,266
Cost of services (exclusive of depreciation and amortization)	55,662	29,391	31,694	116,747
Cost of sales (exclusive of depreciation and amortization)	7,624	6,238	8,623	22,485
Selling, general and administrative expenses	11,481	7,997	5,348	24,826
Depreciation and amortization	8,400	14,131	6,322	28,853
Segment operating income	\$ 30,726	7,623	11,006	49,355
Unallocated corporate costs				\$ 14,544
Consolidated operating income				\$ 34,811

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(3) 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	
	March 31,	
	2008	2007
Reported segment operating income	\$ 41,748	\$ 49,355
Unallocated corporate costs	(16,255)	(14,544)
Consolidated operating income	25,493	34,811
Interest expense	(13,884)	(12,892)
Equity in income of joint ventures	16,859	11,878
Other income (expense), net	(50)	390
Income before income taxes	\$ 28,418	\$ 34,187

In evaluating financial performance, we focus on operating income as a segment's measure of profit or loss. Operating income is 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 Annual Report on Form 10-K for the year ended December 31, 2007).

(4) Equity Investments in Joint Ventures

We are a member of Consorzio Lotterie Nazionali, a consortium consisting principally of our 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 months ended March 31, 2008 and 2007, we recorded income of \$15,116 and \$11,563, respectively, representing our share of the earnings of the consortium for the indicated periods.

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(5) Comprehensive Income

The following presents a reconciliation of net income to comprehensive income for the three month periods ended March 31, 2008 and 2007:

Three Months Ended