

SCIENTIFIC GAMES CORP
Form 10-Q
November 09, 2009
[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, 2009

OR

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

For the transition period from to

Commission file number: 0-13063

SCIENTIFIC GAMES CORPORATION

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

81-0422894
(I.R.S. Employer Identification No.)

750 Lexington Avenue, New York, New York 10022

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 November 6, 2009:

Class A Common Stock: **92,785,148**

Class B Common Stock: **None**

Table of Contents

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

INDEX TO FINANCIAL INFORMATION

AND OTHER INFORMATION

<u>PART I.</u>	<u>FINANCIAL INFORMATION</u>	4
<u>Item 1.</u>	<u>Financial Statements</u>	4
	<u>Consolidated Balance Sheets as of September 30, 2009 and December 31, 2008</u>	4
	<u>Consolidated Statements of Operations for the Three Months Ended September 30, 2009 and 2008</u>	5
	<u>Consolidated Statements of Operations for the Nine Months Ended September 30, 2009 and 2008</u>	6
	<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2009 and 2008</u>	7
	<u>Notes to Consolidated Financial Statements</u>	8
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	46
<u>Item 4.</u>	<u>Controls and Procedures</u>	46
<u>PART II.</u>	<u>OTHER INFORMATION</u>	47
<u>Item 1A.</u>	<u>Risk Factors</u>	47
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 6.</u>	<u>Exhibits</u>	60

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; recent changes to certain contracts; 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; ability to enhance and develop successful gaming concepts; influence of certain stockholders; dependence on suppliers and manufacturers; liability for product defects; 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 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](#)**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

As of September 30, 2009 and December 31, 2008

(Unaudited, in thousands, except per share amounts)

	September 30, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 213,078	\$ 140,639
Accounts receivable, net of allowance for doubtful accounts of \$6,072 and \$6,465 as of September 30, 2009 and December 31, 2008, respectively	212,410	212,487
Inventories	75,758	75,371
Deferred income taxes, current portion	14,684	14,360
Prepaid expenses, deposits and other current assets	67,190	68,921
Total current assets	583,120	511,778
Property and equipment, at cost	1,072,057	1,016,767
Less accumulated depreciation	(506,869)	(441,288)
Property and equipment, net	565,188	575,479
Goodwill, net	777,540	657,211
Intangible assets, net	113,760	120,946
Other assets and investments	297,057	317,039
Total assets	\$ 2,336,665	\$ 2,182,453
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Debt payments due within one year	\$ 138,767	\$ 43,384
Accounts payable	55,561	64,635
Accrued liabilities	162,552	152,665
Total current liabilities	356,880	260,684
Deferred income taxes	34,576	33,809
Other long-term liabilities	87,991	96,048
Long-term debt, excluding current installments	1,189,449	1,196,083
Total liabilities	1,668,896	1,586,624
Commitments and contingencies		
Stockholders equity:		
Class A common stock, par value \$0.01 per share, 199,300 shares authorized, and 92,765 and 92,601 shares outstanding as of September 30, 2009 and December 31, 2008, respectively	928	926
Additional paid-in capital	649,771	628,356

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Accumulated earnings	68,321	58,059
Treasury stock, at cost, 3,130 and 2,608 shares held as of September 30, 2009 and December 31, 2008, respectively	(48,126)	(42,586)
Accumulated other comprehensive income	(3,125)	(48,926)
Total stockholders' equity	667,769	595,829
Total liabilities and stockholders' equity	\$ 2,336,665	\$ 2,182,453

See accompanying notes to consolidated financial statements.

Table of Contents

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

Three Months Ended September 30, 2009 and 2008

(Unaudited, in thousands, except per share amounts)

	Three Months Ended September 30,	
	2009	2008
Operating revenues:		
Services	\$ 222,023	\$ 265,430
Sales	17,123	26,505
	239,146	291,935
Operating expenses:		
Cost of services (exclusive of depreciation and amortization)	127,773	157,480
Cost of sales (exclusive of depreciation and amortization)	10,513	17,257
Selling, general and administrative expenses	38,861	41,937
Depreciation and amortization	32,049	36,487
Operating income	29,950	38,774
Other (income) expense:		
Interest expense	22,736	20,920
Equity in earnings of joint ventures	(14,180)	(13,356)
Early extinguishment of debt	(550)	
Other income, net	(27)	(818)
	7,979	6,746
Income before income taxes	21,971	32,028
Income tax expense	6,865	9,862
Net income	\$ 15,106	\$ 22,166
Basic and diluted net income per share:		
Basic net income per share	\$ 0.16	\$ 0.24
Diluted net income per share	\$ 0.16	\$ 0.23
Weighted-average number of shares used in per share calculations:		
Basic shares	92,727	92,841
Diluted shares	94,028	94,626

See accompanying notes to consolidated financial statements.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****Nine Months Ended September 30, 2009 and 2008****(Unaudited, in thousands, except per share amounts)**

	Nine Months Ended September 30,	
	2009	2008
Operating revenues:		
Services	\$ 650,615	\$ 764,044
Sales	44,249	90,867
	694,864	854,911
Operating expenses:		
Cost of services (exclusive of depreciation and amortization)	377,678	440,394
Cost of sales (exclusive of depreciation and amortization)	30,898	63,808
Selling, general and administrative expenses	119,479	138,003
Employee termination costs	3,920	2,772
Depreciation and amortization	93,453	106,099
Operating income	69,436	103,835
Other (income) expense:		
Interest expense	62,940	55,745
Equity in earnings of joint ventures	(44,758)	(48,612)
(Gain) loss on early extinguishment of debt	(4,594)	2,960
Other income, net	(1,013)	(1,513)
	12,575	8,580
Income before income taxes	56,861	95,255
Income tax expense	46,599	30,672
Net income	\$ 10,262	\$ 64,583
Basic and diluted net income per share:		
Basic net income per share	\$ 0.11	\$ 0.69
Diluted net income per share	\$ 0.11	\$ 0.68
Weighted-average number of shares used in per share calculations:		
Basic shares	92,577	92,933
Diluted shares	93,859	94,588

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, 2009 and 2008

(Unaudited, in thousands, except per share amounts)

	Nine Months Ended September 30,	
	2009	2008
Cash flows from operating activities:		
Net income	\$ 10,262	\$ 64,583
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	93,453	106,099
Change in deferred income taxes	34,350	1,489
Stock-based compensation	25,903	24,348
Non-cash interest expense	11,234	13,184
Undistributed equity in earnings of joint ventures	(13,778)	(24,248)
(Gain) loss on early extinguishment of debt	(4,594)	2,960
Changes in current assets and liabilities, net of effects of acquisitions		
Accounts receivable	4,144	(41,319)
Inventories	2,070	(5,211)
Accounts payable	(8,701)	553
Accrued liabilities	(23,743)	(16,368)
Other current assets and liabilities	45,432	11,078
Other	(38)	4,297
Net cash provided by operating activities	175,994	141,445
Cash flows from investing activities:		
Capital expenditures	(9,135)	(10,886)
Wagering systems expenditures	(44,870)	(119,327)
Other intangible assets and software expenditures	(26,040)	(33,711)
Change in other assets and liabilities, net	3,611	(1,826)
Business acquisitions, net of cash acquired	(89,453)	(3,174)
Net cash used in investing activities	(165,887)	(168,924)
Cash flows from financing activities:		
Net repayments under revolving credit facility		(158,000)
Proceeds from issuance of long-term debt	259,658	797,243
Payment on long-term debt	(183,632)	(447,069)
Payment of financing fees	(11,535)	(15,085)
Purchases of treasury stock	(5,539)	(18,017)
Net proceeds from issuance of common stock	2,191	3,020
Net cash provided by financing activities	61,143	162,092
Effect of exchange rate changes on cash and cash equivalents	1,189	(2,246)
Increase in cash and cash equivalents	72,439	132,367
Cash and cash equivalents, beginning of period	140,639	29,403
Cash and cash equivalents, end of period	\$ 213,078	\$ 161,770

See accompanying notes to consolidated 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, 2009, the Consolidated Statements of Operations for the three and nine months ended September 30, 2009 and 2008, and the Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2009 and 2008, 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, 2009, the results of our operations for the three and nine months ended September 30, 2009 and 2008 and our cash flows for the nine months ended September 30, 2009 and 2008 have been made. Management has evaluated subsequent events through the date of financial statement issuance on November 9, 2009.

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 Current Report on Form 8-K filed on May 18, 2009 (which retrospectively adjusted portions of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008 to reflect a change in accounting principle to reflect our adoption, effective January 1, 2009, of new Financial Accounting Standards Board (FASB) guidance on accounting for convertible debt instruments that may be settled in cash upon conversion). The results of operations for the period ended September 30, 2009 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, 2009 and 2008:

**Three Months Ended
September 30,**

**Nine Months Ended
September 30,**

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

	2009	2008	2009	2008
Income (numerator)				
Net income	\$ 15,106	\$ 22,166	\$ 10,262	\$ 64,583
Shares (denominator)				
Weighted-average basic common shares outstanding	92,727	92,841	92,577	92,933
Effect of dilutive securities-stock rights	1,301	1,785	1,282	1,649
Effect of dilutive shares related to convertible debentures				6
Weighted-average diluted common shares outstanding	94,028	94,626	93,859	94,588
Basic and diluted per share amounts				
Basic net income per share	\$ 0.16	\$ 0.24	\$ 0.11	\$ 0.69
Diluted net income per share	\$ 0.16	\$ 0.23	\$ 0.11	\$ 0.68

The weighted-average diluted common shares outstanding for the three and nine months ended September 30, 2009 excludes the effect of approximately 5,774 and 6,470 weighted-average stock rights outstanding, respectively, because their effect would be anti-dilutive. The weighted-average diluted common shares outstanding for the three and nine months ended September 30, 2008 excludes the effect of approximately 3,744 and 3,563 weighted-average stock rights outstanding, respectively, because their effect would be anti-dilutive.

The aggregate number of shares that we could be obligated to issue upon conversion of the remaining \$99,191 in aggregate principal amount of our 0.75% convertible senior subordinated notes due 2024 (the Convertible Debentures), is approximately 3,409. 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 each of the first, second and third quarters of 2009, 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 and nine months ended September 30, 2009. 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 nine-month period ended September 30, 2008.

(2) Operating Segment Information

We operate in three segments. Our Printed Products Group provides lotteries with instant tickets 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 access to a licensed property portfolio 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, 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, 2009 and 2008, by reportable segments. Corporate expenses, including interest expense, other income, and depreciation and amortization, are not allocated to the reportable segments.

	Three Months Ended September 30, 2009			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 117,744	\$ 52,343	\$ 51,936	\$ 222,023
Sales revenues	3,035	13,144	944	17,123
Total revenues	\$ 120,779	\$ 65,487	\$ 52,880	\$ 239,146
Cost of services (exclusive of depreciation and amortization)	\$ 69,897	\$ 26,741	\$ 31,135	\$ 127,773
Cost of sales (exclusive of depreciation and amortization)	2,199	7,733	581	10,513
Selling, general and administrative expenses	11,768	8,169	5,614	25,551
Depreciation and amortization	8,216	11,452	12,209	31,877
Segment operating income	\$ 28,699	\$ 11,392	\$ 3,341	\$ 43,432
Unallocated corporate costs				13,482
Consolidated operating income				\$ 29,950

	Three Months Ended September 30, 2008			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
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

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Segment operating income	\$	35,085	\$	10,979	\$	8,291	\$	54,355
Unallocated corporate costs								15,581
Consolidated operating income							\$	38,774

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)

	Nine Months Ended September 30, 2009			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Service revenues	\$ 340,616	\$ 159,414	\$ 150,585	\$ 650,615
Sales revenues	9,776	31,088	3,385	44,249
Total revenues	\$ 350,392	\$ 190,502	\$ 153,970	\$ 694,864
Cost of services (exclusive of depreciation and amortization)	\$ 202,608	\$ 83,511	\$ 91,559	\$ 377,678
Cost of sales (exclusive of depreciation and amortization)	6,728	22,027	2,143	30,898
Selling, general and administrative expenses	34,141	23,042	17,283	74,466
Employee termination costs	2,016	125	433	2,574
Depreciation and amortization	24,095	32,882	35,959	92,936
Segment operating income	\$ 80,804	\$ 28,915	\$ 6,593	\$ 116,312
Unallocated corporate costs				45,530
Corporate employee termination costs				1,346
Consolidated operating income				\$ 69,436

	Nine Months Ended September 30, 2008			
	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
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	45,088	25,742	19,493	90,323
Employee termination costs	2,772			2,772
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

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 consolidated income before income taxes for each period:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Reported segment operating income	\$ 43,432	\$ 54,355	\$ 116,312	\$ 152,347
Unallocated corporate costs	(13,482)	(15,581)	(45,530)	(48,512)
Corporate employee termination costs			(1,346)	
Consolidated operating income	29,950	38,774	69,436	103,835
Interest expense	(22,736)	(20,920)	(62,940)	(55,745)
Equity in income of joint ventures	14,180	13,356	44,758	48,612
Gain (loss) on early extinguishment of debt	550		4,594	(2,960)
Other income, net	27	818	1,013	1,513
Income before income taxes	\$ 21,971	\$ 32,028	\$ 56,861	\$ 95,255

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 Current Report on Form 8-K, filed on May 18, 2009).

(3) Equity Investments in Joint Ventures

We are a member of Consorzio Lotterie Nazionali (CLN), a consortium consisting principally of us, Lottomatica S.p.A, and Arianna 2001, a company owned by the Federation of Italian Tobacconists. The consortium holds a concession from the Italian Monopoli di Stato to be the exclusive operator of the Italian Gratta e Vinci instant lottery. The concession commenced in mid-2004 and has an initial term of six years with a six-year extension option at the option of the Monopoli di Stato. Under our contract with CLN, we supply instant lottery tickets, game development services, marketing support, the instant ticket management system and systems support. We also participate in the profits or losses of CLN 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, 2009, we recorded income of \$11,235 and \$37,812, respectively, representing our share of the earnings of CLN in each period. 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 CLN for the indicated periods. During the second quarter of 2009, we received a cash distribution of approximately \$28.0 million from CLN.

On October 12, 2009, the members of CLN tendered for a new concession to operate the Gratta e Vinci instant ticket lottery upon the termination of CLN's current concession. Although a maximum of four concessions can be granted by the terms of the tender, we understand that our bidding group was the only group to submit a bid. The concession, anticipated to begin in June 2010, will have an initial term of nine years (subject to a performance evaluation during the fifth year) and may be extended by the Monopoli di Stato for an additional nine years. Pricing for the new concession is set at 11.9% of retail sales, inclusive of retailer commissions of 8.0%, compared to the current tiered pricing structure, which averaged 12.1% of retail sales in the second quarter of 2009 inclusive of retailer commissions of 8.0% and a value-added tax (VAT). The new rate is exclusive of VAT; however VAT will be charged on the operating expenses of the concessionaire.

A non-bidding third party filed a request with the TAR Lazio (Rome Administrative Court) seeking the suspension and annulment of the tender. We understand that the request claims that the tender is discriminatory and that it unlawfully limits competition. The request to suspend the tender was denied in hearings on October 14 and October 28, 2009. Another hearing has been scheduled for November 11, 2009 to address the request for annulment. We currently expect the results of the tender to be published in mid-November 2009. In the event that the request for annulment is granted, we cannot predict what actions, if any, the Italian government or Monopoli di Stato will take, including potentially passing new legislation, amending the tender procedures, issuing new tender procedures or exercising its option to extend CLN's current concession.

In the event that our bidding group is the sole bidding group to be awarded a concession, our bidding group would be obligated to make upfront payments of 520,000 and 280,000 on or about November 30, 2009 and November 30, 2010, respectively. We would be responsible for our pro rata share of these payments (which would be 104,000 and 56,000, respectively, assuming our ownership interest in the entity that holds the concession remains at 20%). In conjunction with the submission of its bid, our bidding group provided bank guarantees to support a 40,000 bid guarantee and a 75,000 performance guarantee. We guaranteed our pro rata share of these guarantees through the issuance of 23,000 of letters of credit under our revolving credit facilities.

There can be no assurance that our bidding group will be awarded a concession to continue to operate the instant ticket lottery following the termination of CLN's current concession or whether other operators will also be awarded a concession. In addition, there can be no assurance that we will continue to supply instant lottery tickets and/or other services under any future arrangements. In the event that our bidding group is awarded a concession, we anticipate that our bidding group will form and capitalize a new vehicle to hold the concession consistent with the tender requirements. We have entered into a memorandum of understanding with our current CLN partners with respect to the formation and governance of any new concession vehicle on terms substantially similar to the terms governing CLN. However, we cannot guarantee that we will be able to enter into definitive governing agreements, nor can we predict the final terms of any such definitive agreements (including terms relating to the structure of the vehicle and governance rights).

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, 2009 and 2008:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Net income	\$ 15,106	\$ 22,166	\$ 10,262	\$ 64,583
Other comprehensive income (loss):				
Foreign currency translation gain (loss)	5,343	(40,808)	43,651	(22,180)
Gain on derivative financial instruments	1,349		2,150	
Unrealized loss on investments				(181)
Other comprehensive income	6,692	(40,808)	45,801	(22,361)
Comprehensive income	\$ 21,798	\$ (18,642)	\$ 56,063	\$ 42,222

(5) Inventories

Inventories consist of the following:

	September 30, 2009	December 31, 2008
Parts and work-in-process	\$ 29,351	\$ 36,449
Finished goods	46,407	38,922
	\$ 75,758	\$ 75,371

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

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

On May 21, 2009, Scientific Games International, Inc. (SGI) issued \$225,000 in aggregate principal amount of its 9.25% Senior Subordinated Notes due 2019 (the 2009 Notes) at an issue price of 96.823% of the principal amount. The 2009 Notes were issued pursuant to an indenture dated as of May 21, 2009 (the 2009 Notes Indenture) among SGI, as issuer, the Company, as a guarantor, the Company's subsidiary guarantors party thereto and The Bank of Nova Scotia Trust Company of New York, as trustee.

The 2009 Notes bear interest at the rate of 9.25% per annum, which accrues from May 21, 2009 and is payable semiannually in arrears on June 15 and December 15 of each year, commencing on December 15, 2009. The 2009 Notes mature on June 15, 2019, unless earlier redeemed or repurchased, and are subject to the terms and conditions set forth in the 2009 Notes Indenture.

SGI may redeem some or all of the 2009 Notes at any time prior to June 15, 2014 at a price equal to 100% of the principal amount of the 2009 Notes plus accrued and unpaid interest, if any, to the date of redemption plus a make whole premium. SGI may redeem some or all of the 2009 Notes for cash at any time on or after June 15, 2014 at the prices specified in the 2009 Notes Indenture. In addition, at any time on or prior to June 15, 2012, SGI may redeem up to 35% of the initially outstanding aggregate principal amount of the 2009 Notes at a redemption price of 109.25% 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 the 2009 Notes is required to be licensed, qualified or found suitable under any applicable gaming laws or regulations and that holder does not become so licensed or qualified or is not found to be suitable, then SGI will have the right to, subject to certain notice provisions set forth in the 2009 Notes Indenture, (1) require that holder to dispose of all or a portion of those Notes or (2) redeem the 2009 Notes of that holder at a redemption price calculated as set forth in the 2009 Notes

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)

Indenture. If the Company or SGI experiences specific kinds of changes in control or the Company or any of its restricted subsidiaries sells certain of its assets, then SGI must offer to repurchase the 2009 Notes on the terms set forth in the 2009 Notes Indenture.

The 2009 Notes are unsecured senior subordinated obligations of SGI and 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 2009 Notes. The 2009 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The 2009 Notes are guaranteed on an unsecured senior subordinated basis by the Company and all of its 100%-owned domestic subsidiaries (other than SGI). The guarantees of the 2009 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 2009 Notes. The 2009 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The 2009 Notes 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 assets 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 2009 Notes Indenture contains events of default customary for agreements of its type (with customary grace periods, as applicable) and provides that, upon the occurrence of an event of default arising from certain events of bankruptcy or insolvency with respect to the Company or SGI, all outstanding Notes will become due and payable immediately without further action or notice. If any other type of event of default occurs and is continuing, then the trustee or the holders of at least 25% in principal amount of the then outstanding Notes may declare all the 2009 Notes to be due and payable immediately.

The 2009 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 in connection with the issuance of the 2009 Notes, SGI, the Company, the Company's subsidiary guarantors party thereto, and J.P. Morgan Securities Inc., Banc of America Securities LLC, Credit Suisse Securities (USA) LLC and Goldman, Sachs & Co., as representatives for the initial purchasers listed therein, entered into a registration rights agreement, dated May 21, 2009 (the "Registration Rights Agreement"). Under the Registration Rights Agreement, SGI and the guarantors agreed, for the benefit of the holders of the 2009 Notes, that they will file with the Securities and Exchange Commission (the "SEC") within 90 days after the date the 2009 Notes were issued, and use their commercially reasonable efforts to cause to

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

become effective, a registration statement relating to an offer to exchange the 2009 Notes for an issue of SEC-registered notes (the 2009 Exchange Notes) with terms identical to the 2009 Notes (except that the 2009 Exchange Notes will not be subject to restrictions on transfer or to any increase in annual interest rate as described below).

On September 17, 2009, the Company filed a Registration Statement with the SEC under Form S-4 pursuant to which SGI, offered to exchange all outstanding 2009 Notes that are validly tendered and not validly withdrawn for an equal principal amount of 2009 Exchange Notes that are, subject to specified conditions, freely transferable. The exchange offer was launched on September 15, 2009 and expired at 5:00 p.m., New York City time, on October 26, 2009.

On May 7, 2009, the Company entered into an agreement with the principal selling shareholder and key management of Global Draw Limited (Global Draw) related to the earn-out and contingent bonuses that were payable to them in connection with the Company s 2006 acquisition. Based on the performance of the business, the total amount payable was determined to be approximately £60,600 of which approximately £30,500 was paid in May 2009. Approximately £28,100 of the total amount payable

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)

was deferred under the terms of two-year, senior unsecured promissory notes issued by certain of the Company's foreign subsidiaries (and guaranteed by the Company and certain of its U.S. subsidiaries). The earn-out balance of approximately £2,000 was paid in September 2009.

The promissory note issued to the principal selling shareholder, which was executed on May 7, 2009 by Scientific Games Luxembourg Finance S.a.r.l. (SGLF), an indirect 100%-owned subsidiary of the Company, has a principal amount of approximately £26,000 and bears simple interest at the rate of 6.90% per annum, which interest is payable quarterly in arrears on the last day of March, June, September and December of each year, commencing on June 30, 2009. The note matures on May 7, 2011. Although not required to do so (except in connection with an event of default as described below), SGLF may repay all or a portion of the principal amount of the note at any time prior to maturity without premium or penalty. The note is a senior unsecured obligation of SGLF and is guaranteed on a joint and several basis by the Company and certain of its 100%-owned domestic subsidiaries (including SGI). Such guaranty represents senior debt as that term is defined in the indentures governing the Company's 6.25% Senior Subordinated Notes due 2012 (the 2004 Notes), the Convertible Debentures, SGI's 7.875% Senior Subordinated Notes due 2016 (the 2008 Notes) and the 2009 Notes.

If an event of default under the note shall occur and be continuing, the holder of the note may declare the principal amount of, and accrued interest on, the note to be immediately due and payable. An event of default under the note shall occur if (1) SGLF shall fail to pay the then unpaid principal amount under the note within 15 days after the maturity date or any interest payment that is due and payable within 15 days after the applicable interest payment date, or (2) an event of default (as defined in the Credit Agreement (as defined below)) shall occur and be continuing and, as a result thereof, the amounts owing under the Credit Agreement immediately become due and payable.

The terms of the promissory notes issued to key management of Global Draw and the related guaranties are substantially identical to the note and guaranties described above, except that one of the notes was issued by a different foreign subsidiary of the Company.

On March 27, 2009, we and our 100%-owned subsidiary, SGI, entered into an amendment (the First Amendment) to the credit agreement, dated as of June 9, 2008 (the Credit Agreement), among SGI, as borrower, the Company, as guarantor, the several lenders from time to time parties thereto and JPMorgan Chase Bank, N.A. (JPMorgan), as administrative agent. The purpose of the First Amendment was to provide the Company with additional operating and financing flexibility.

Under the First Amendment, (i) up to approximately \$18,800 in certain charges incurred and reserves created in the fourth quarter of 2008, (ii) up to \$15,000 of certain charges that may be incurred during the 12-month period commencing on March 1, 2009, including charges in connection with cost-reduction initiatives, and (iii) certain costs and fees incurred in connection with the First Amendment, will be added back to Consolidated EBITDA for purposes of calculating the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio (as such terms

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

are defined under the Credit Agreement). In addition, for purposes of determining the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio as of any date prior to the earliest date on which any of the holders of Convertible Debentures may require the Company to repurchase their Convertible Debentures (currently June 1, 2010) (the Convertible Debentures Repurchase Date) neither (i) the earn-out payable with respect to the Company's acquisition of Global Draw nor (ii) the principal amount of any unsecured promissory notes that may be issued in order to defer payment of up to the equivalent of \$60,000 of such earn-out (provided that, among other terms of such promissory notes, no principal payment thereon is required prior to September 30, 2010), will be included as Indebtedness in the calculation of Consolidated Total Debt (as such terms are defined in the Credit Agreement). Accordingly, the promissory notes described above that were issued to the principal selling shareholder and key management of Global Draw will not be included as Indebtedness in the calculation of Consolidated Total Debt for purposes of determining the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio prior to the Convertible Debenture Repurchase Date.

In conjunction with the promissory notes issued to defer payment of a portion of the Global Draw earn-out, the revolving credit facility and the term loan facility under the Credit Agreement will mature (if earlier than the date that would otherwise apply under the terms of the Credit Agreement) on February 7, 2011 unless on such date no such promissory notes remain outstanding or the sum of the aggregate available revolving commitments under the Credit Agreement plus unrestricted cash and cash equivalents of SGI and the guarantors under the Credit Agreement is not less than \$50,000 in excess of the amount required to repay in full such outstanding promissory notes.

Under the First Amendment, for purposes of determining the Consolidated Leverage Ratio as of any date of determination prior to the earlier of the Convertible Debentures Repurchase Date and the date the Convertible Debentures are redeemed in full, unrestricted cash and cash equivalents of SGI and the guarantors up to the Debenture Reserve Amount at such determination date will be netted against the then outstanding principal amount of the Convertible Debentures (and Consolidated Total Debt will be thereby reduced to the extent of such netting). The Debenture Reserve Amount is an amount equal to the net cash proceeds received by SGI or the guarantors after the date of the First Amendment and prior to the Convertible Debentures Repurchase Date from (i) the issuance by the

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)

Company of shares of its capital stock (other than disqualified stock), or the issuance of Permitted Additional Senior Indebtedness or Permitted Additional Subordinated Debt, or Indebtedness under the Incremental Facilities (as such terms are defined in the Credit Agreement), and (ii) any Asset Sales (as defined in the Credit Agreement) (up to an aggregate of \$125,000 of net cash proceeds) with respect to which a reinvestment notice is timely given (provided that the Debenture Reserve Amount will (A) not exceed the outstanding principal amount of the Convertible Debentures, (B) be reduced to zero on the Convertible Debentures Repurchase Date and (C) to the extent the Debenture Reserve Amount is increased as a result of Assets Sales, will be decreased if and to the extent that term loans under the Credit Agreement are prepaid in lieu of reinvesting the net cash proceeds there from pursuant to a reinvestment notice). The 2009 Notes constitute Permitted Additional Subordinated Debt and, as such, the net cash proceeds from the issuance of such notes will be included in the Debenture Reserve Amount to the extent permitted under the First Amendment.

The First Amendment increased each of the interest rates set forth in the pricing grid in the Credit Agreement by 0.25% such that, depending upon the Consolidated Leverage Ratio, the interest rate will vary from 2.00% to 3.00% above LIBOR for eurocurrency loans, and 1.00% to 2.00% above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50% for base rate loans. Notwithstanding the foregoing, from the Effective Date (as defined in the Credit Agreement) until September 30, 2009, the applicable margin for eurocurrency loans was deemed to be 3.00% and the applicable margin for base rate loans was deemed to be 2.00%.

In connection with the First Amendment, SGI agreed to pay an aggregate of approximately \$2,800 in fees to consenting lenders and the administrative agent.

On September 30, 2009, the Company and SGI entered into a second amendment (the Second Amendment) to the Credit Agreement. The primary purpose of the Second Amendment was to facilitate our ability to participate in the recently announced competitive tender process for a license to sell instant lottery tickets under the Gratta e Vinci lottery in Italy.

The Second Amendment provides that certain payments, costs and obligations made or incurred by any of the Company or its subsidiaries, whether directly or indirectly, in connection with any award of a license to operate the instant ticket lottery (the Italian Concession), including any up-front fee required under the tender process (collectively, Italian Concession Obligations), will be permitted, subject to certain limitations, under the Credit Agreement covenant restricting Investments (as defined in the Credit Agreement) (to the extent such Italian Concession Obligations are deemed to be Investments under the Credit Agreement). Certain Guarantee Obligations (as defined in the Credit Agreement) incurred by any of the Company or its subsidiaries in respect of certain Italian Concession Obligations will be permitted under the Credit Agreement covenant restricting Indebtedness. In addition, the Second Amendment provides that certain Italian Concession Obligations paid or incurred in an applicable period will be added back to the definition of Consolidated EBITDA to the extent such Italian Concession Obligations are treated as an expense in the period paid or incurred.

The Second Amendment provides further that, in lieu of any required prepayment of term loans under the Credit Agreement, the net cash proceeds from any Asset Sale or Recovery Event (as defined in the Credit Agreement) may, during the 12-month reinvestment period, be applied to make or incur any Investment to fund or satisfy any Italian Concession Obligations not yet made or satisfied (or, under certain circumstances, may be deemed to apply to any Investment that is made or incurred to fund or satisfy Italian Concession Obligations already funded or satisfied).

In addition, pursuant to the Second Amendment, we will be required to maintain the following revised financial ratios during the following relevant periods:

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Table of Contents

- a Consolidated Leverage Ratio as at the last day of each fiscal quarter no more than 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 September 30, 2009);
 - 4.75 to 1.00 (fiscal quarter ended December 31, 2009 through December 31, 2010);
 - 4.50 to 1.00 (fiscal quarter ended March 31, 2011 through December 31, 2011);
 - 4.25 to 1.00 (fiscal quarter ended March 31, 2012 through September 30, 2012); and
 - 4.00 to 1.00 (fiscal quarter ending December 31, 2012 and thereafter);
- a Consolidated Senior Debt Ratio as at the last day of each fiscal quarter no more than the ratio set forth below with respect to such fiscal quarter or with respect to the period during which such fiscal quarter ends:
 - 2.50 to 1.00 (fiscal quarter ended June 30, 2008 through September 30, 2009);
 - 2.75 to 1.00 (fiscal quarter ended December 31, 2009 through December 31, 2010); and
 - 2.50 to 1.00 (fiscal quarter ended March 31, 2011 and thereafter);
- a Consolidated Interest Coverage Ratio (as defined in the Credit Agreement) for any period of four consecutive fiscal quarters of not less than the ratio set forth below with respect to such period or with respect to the period during which such four consecutive fiscal quarters ends:
 - 3.50 to 1.00 (four consecutive fiscal quarters ending on or prior to September 30, 2009); and

- 3.00 to 1.00 (four consecutive fiscal quarters ending December 31, 2009 and thereafter).

Pursuant to the Second Amendment, certain additional dispositions will be permitted under the Credit Agreement covenant restricting Dispositions, including, subject to certain limitations, dispositions pursuant to certain permitted investments such as permitted investments in Non-Guarantor Subsidiaries, joint ventures and Permitted Acquisitions (such terms are defined in the Credit Agreement).

The interest rates set forth in the pricing grid in the Credit Agreement will be unchanged, except that, pursuant to the Second Amendment, an interest rate level will be added to the top of the grid such that, if the Consolidated Leverage Ratio as of the most recent determination date is equal to or greater than 4.25 to 1 (and, in any event, for the six-month period beginning on September 30, 2009), the interest rate will be 3.25% above LIBOR for eurocurrency loans, and 2.25% above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50% for base rate loans.

The Second Amendment also provides that the commitment fee rate payable in respect of the available revolving credit facility commitments under the Credit Agreement will be (i) 0.50% per annum if the Consolidated Leverage Ratio as of the most recent determination date is less than 4.25 to 1.00 or (ii) 0.75% per annum if the Consolidated Leverage Ratio as of the most recent determination date is greater than or equal to 4.25 to 1.00 (and, in any event, for the six-month period beginning on September 30, 2009).

In connection with the Second Amendment, SGI agreed to pay an aggregate of approximately \$2,800 in fees to consenting lenders and the administrative agent.

On September 30, 2009, we had \$201,408 of availability under our revolving credit facility. There were no borrowings and \$48,592 in outstanding letters of credit under our revolving credit facility as of September 30, 2009.

We were in compliance with our debt covenants as of September 30, 2009.

The Company may, from time to time, seek to retire or purchase its outstanding debt in open market purchases, in privately negotiated transactions, or otherwise. Any such retirement or purchase of debt may be funded by cash flows from operations, borrowings or other sources and will depend upon prevailing market conditions, liquidity requirements, contractual restrictions and other factors, and the amounts involved may be material. During the three and nine months ended September 30, 2009, we repurchased approximately \$43,188 and \$174,591, respectively, in aggregate principal amount of our Convertible Debentures for approximately \$42,369 and \$166,372, respectively, in cash under our previously announced Convertible Debenture repurchase program. During the three and nine months ended September 30, 2009, we recognized a gain on early extinguishment of debt of approximately \$550 and \$4,239, respectively, from the Convertible Debenture repurchase program. During the nine months ended September 30, 2009, we repurchased approximately \$12,925 in aggregate principal amount of our 2004 Notes for approximately \$12,396 in cash under our previously announced 2004 Notes repurchase program. During the nine months ended September 30, 2009, we recognized a gain on early extinguishment of debt of approximately \$355 from the 2004 Notes repurchase program.

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)

During the second and third quarters of 2009, in connection with repurchases made under our Convertible Debenture repurchase program, we unwound a corresponding portion of the convertible bond hedge and warrant option transactions that we entered into in December 2004 in connection with the original issuance of the Convertible Debentures such that the number of call options held by us under the bond hedge was reduced from 275 to approximately 99 and the number of warrants held by the warrant counterparties was reduced from approximately 9,450 to approximately 3,409. We received a net cash settlement of approximately \$130 and \$1,334, respectively, during the three and nine months ended September 30, 2009 as a result of this unwinding of a portion of the convertible bond hedge and warrant option transactions. For additional information on the bond hedge and warrants, refer to Note 8 of the Notes to Consolidated Financial Statements included in our Current Report on Form 8-K filed on May 18, 2009.

On January 1, 2009, we adopted new FASB guidance on accounting for convertible debt instruments that may be settled in cash upon conversion (the New Convertible Debt Guidance). The New Convertible Debt Guidance clarifies that convertible debt instruments that may be settled in cash upon conversion are not addressed by previous convertible debt accounting guidance and 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. The New Convertible Debt Guidance was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and was required to be applied retrospectively to all periods presented. The impact of adoption was an adjustment to accumulated earnings of approximately \$22,600 representing the cumulative effect of a change in accounting principle as of January 1, 2007.

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)**

The adoption of the New Convertible Debt Guidance had the following effect on our Consolidated Statements of Operations for the three and nine months ended September 30, 2008:

	Three Months Ended September 30, 2008			Nine Months Ended September 30, 2008		
	Previously Reported	As Adjusted	Effect of Change	Previously Reported	As Adjusted	Effect of Change
Interest expense	\$ 17,659	\$ 20,920	\$ 3,261	\$ 45,962	\$ 55,745	\$ 9,783
Income tax expense	9,879	9,862	(17)	30,725	30,672	(53)
Net income	25,410	22,166	(3,244)	74,313	64,583	(9,730)
Basic net income per share	\$ 0.27	\$ 0.24	\$ (0.03)	\$ 0.80	\$ 0.69	\$ (0.11)
Diluted net income per share	\$ 0.27	\$ 0.23	\$ (0.04)	\$ 0.79	\$ 0.68	\$ (0.11)

The adoption of the New Convertible Debt Guidance had the following effect on our Consolidated Balance Sheet as of December 31, 2008:

	December 31, 2008		
	Previously Reported	As Adjusted	Effect of Change
Other assets and investments	\$ 317,818	\$ 317,039	\$ (779)
Long-term debt, excluding current installments	1,216,264	1,196,083	(20,181)
Additional paid-in capital	561,202	628,356	67,154
Accumulated earnings	105,811	58,059	(47,752)

As of January 1, 2008, the cumulative effect of the change in accounting principle on accumulated earnings and additional paid-in capital was approximately \$34,800 and \$67,200, respectively.

The adoption of the New Convertible Debt Guidance had the following effect on our Consolidated Statement of Cash Flows for the nine months ended September 30, 2008:

Nine Months Ended September 30, 2008

	Previously Reported	As Adjusted	Effect of Change
--	--------------------------------	------------------------	-----------------------------

Cash flows from operating activities:			
Net income	\$ 74,313	\$ 64,583	\$ (9,730)
Change in deferred income taxes	1,542	1,489	(53)
Non-cash interest expense	3,401	13,184	9,783

As of September 30, 2009 and December 31, 2008, the equity component of the Convertible Debentures under the New Convertible Debt Guidance was approximately \$62,234 and \$68,592, respectively. The following represents the principal amount of the liability component, the unamortized discount, and the net carrying amount of our convertible debt instruments as of September 30, 2009 and December 31, 2008, respectively:

	September 30, 2009	December 31, 2008
Principal	\$ 99,191	\$ 273,782
Unamortized discount	(3,439)	(20,181)
Net carrying amount	\$ 95,752	\$ 253,601

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)

As of September 30, 2009, the remaining discount will be amortized over a period of approximately eight months. The conversion price of the remaining \$99,191 in aggregate principal amount of the Convertible Debentures is \$29.10 and the aggregate number of shares that we could be obligated to issue upon conversion is approximately 3,409.

The effective interest rate on the liability component of the Convertible Debentures is approximately 6.25% for the three and nine months ended September 30, 2009 and 2008. The amount of interest cost recognized for the contractual interest coupon during the three and nine months ended September 30, 2009 was approximately \$213 and \$1,109, respectively. The amount of interest cost recognized for the contractual interest coupon during the three and nine months ended September 30, 2008 was approximately \$513 and \$1,540, respectively. The amount of interest cost recognized for the amortization of the discount on the liability component of the Convertible Debentures during the three and nine months ended September 30, 2009 was approximately \$1,514 and \$7,598, respectively. The amount of interest cost recognized for the amortization of the discount on the liability component of the Convertible Debentures during the three and nine months ended September 30, 2008 was approximately \$3,362 and \$9,783, respectively.

(7) Derivative Financial Instruments

Effective October 17, 2008, SGI entered into a three-year interest rate swap agreement (the Hedge) with JPMorgan. Under the Hedge, which is designated as a cash flow hedge, SGI pays interest on a \$100,000 notional amount of debt at a fixed rate of 3.49% and receives interest on a \$100,000 notional amount of debt at the prevailing three-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 \$100,000 of our variable-rate debt. As of September 30, 2009, the Hedge was measured at a fair value of \$4,490 using Level 2 valuation techniques of the fair value hierarchy and included in other long-term liabilities on the Consolidated Balance Sheet.

We believe we have matched the critical terms of the hedged variable-rate debt with the Hedge and expect the Hedge to be highly effective in offsetting changes in the expected cash flows due to fluctuation in the three-month LIBOR-based rate over the term of the forecasted interest payments related to the \$100,000 notional amount of variable-rate debt. Hedge effectiveness is measured quarterly on a retrospective basis using the cumulative dollar-offset approach in which the cumulative changes in the cash flows of the actual swap are compared to the cumulative changes in the cash flows of the hypothetical swap. The effective portion of the Hedge is recorded in other comprehensive income (loss) and the ineffective portion of the Hedge, if any, is recorded in the Consolidated Statement of Operations. During the three and nine months ended September 30, 2009, we recorded a gain of approximately \$1,349 and \$2,150, respectively in other comprehensive income (loss). There was no ineffective portion of the Hedge recorded in the Consolidated Statement of Operations. Amounts recorded in other comprehensive income (loss) that were deferred on the effective hedged forecasted transactions are reclassified to earnings when the interest expense related to the hedged item affects earnings.

Table of Contents

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(8) Goodwill and Intangible Assets

The following disclosure presents certain information regarding our acquired intangible assets as of September 30, 2009 and December 31, 2008. Amortizable intangible assets are amortized over their estimated useful lives with no estimated residual values.

Intangible Assets	Gross Carrying Amount	Accumulated Amortization	Net Balance
Balance as of September 30, 2009			
Amortizable intangible assets:			
Patents	\$ 12,117	\$ (3,506)	\$ 8,611
Customer lists	29,774	(17,004)	12,770
Customer service contracts	3,994	(2,770)	1,224
Licenses	63,917	(39,515)	24,402
Intellectual property	18,694	(15,924)	2,770
Lottery contracts	31,212	(30,678)	534
	159,708	(109,397)	50,311
Non-amortizable intangible assets:			
Trade name	37,827	(2,118)	35,709
Connecticut off-track betting system operating right	36,059	(8,319)	27,740
	73,886	(10,437)	63,449
Total intangible assets	\$ 233,594	\$ (119,834)	\$ 113,760
Balance as of December 31, 2008			
Amortizable intangible assets:			
Patents	\$ 11,563	\$ (2,871)	\$ 8,692
Customer lists	28,772	(14,044)	14,728
Customer service contracts	3,892	(2,505)	1,387
Licenses	60,237	(32,615)	27,622
Intellectual property	17,057	(11,425)	5,632
Lottery contracts	27,926	(27,498)	428
	149,447	(90,958)	58,489
Non-amortizable intangible assets:			
Trade name	37,285	(2,118)	35,167
Connecticut off-track betting system operating right	35,609	(8,319)	27,290
	72,894	(10,437)	62,457
Total intangible assets	\$ 222,341	\$ (101,395)	\$ 120,946

The aggregate intangible amortization expense for the three and nine months ended September 30, 2009 was approximately \$4,400 and \$13,600, respectively. The aggregate intangible amortization expense for the three and nine months ended September 30, 2008 was approximately \$6,900 and \$21,800, respectively.

Table of Contents

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(8) 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, 2008 to September 30, 2009. In 2009, we recorded (a) a \$86,937 increase in goodwill associated with the final purchase price adjustment in accordance with the Global Draw earn-out, and (b) an increase in goodwill of \$33,392 as a result of foreign currency translation.

Goodwill	Printed Products Group	Lottery Systems Group	Diversified Gaming Group	Totals
Balance as of December 31, 2008	\$ 324,245	\$ 190,341	\$ 142,625	\$ 657,211
Adjustments	3,999	2,554	113,776	120,329
Balance as of September 30, 2009	\$ 328,244	\$ 192,895	\$ 256,401	\$ 777,540

(9) Pension and Other Post-Retirement Plans

We have defined benefit pension plans for our U.S.-based union employees, our U.K.-based union employees, and certain Canadian-based employees (the U.S. Plan, the U.K. Plan and the Canadian Plan, respectively). 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 the three and nine months ended September 30, 2009 and 2008.

Components of net periodic pension benefit cost:	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Service cost	\$ 371	\$ 713	\$ 1,114	\$ 1,964
Interest cost	1,052	1,366	3,156	3,079
Expected return on plan assets	(888)	(1,440)	(2,665)	(3,487)

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Amortization of actuarial losses	119	280	357	758
Amortization of prior service costs	11	11	32	32
Net periodic cost	\$ 665	\$ 930	\$ 1,994	\$ 2,346

We have a 401(k) plan for U.S.-based employees who are not covered by a collective bargaining agreement. Effective February 28, 2009, we reduced the matching contributions from 50 cents to 25 cents on the dollar for the first 6% of participant contributions for a match of up to 1.5% of eligible compensation.

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****(10) Income Taxes**

The effective tax rates of 31.2% and 82.0%, respectively, for the three and nine months ended September 30, 2009 were determined using an estimated annual effective tax rate. The effective tax rate for the three and nine months ended September 30, 2009 includes the impact of a valuation allowance against the deferred tax asset related to foreign tax credits and the release of certain FIN 48 reserves related to tax settlements in the third quarter. The effective tax rates of 30.8% and 32.2%, 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 earnings from operations outside the United States.

At December 31, 2008, the Company had a deferred tax asset for its foreign tax credit (FTC) carry forward of approximately \$40,400. The Company has and will continue to explore tax planning strategies to use all of its FTC but at March 31, 2009, the Company established a valuation allowance of approximately \$33,833 against the FTC deferred tax asset to reduce the asset to the net amount management estimates is more likely than not to be realized.

Further, the Company determined it is not more likely than not that the foreign taxes generated in 2009 will be realized in full against its U.S. tax liability during the FTC carry forward period. As a result, the Company's 2009 annual effective income tax rate is greater than the federal statutory rate because of the valuation allowance established against the deferred tax asset for a portion of the FTC generated in 2009.

(11) 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, 2009 and during the fiscal year ended December 31, 2008:

	Three Months Ended September 30, 2009	Twelve Months Ended December 31, 2008
Shares outstanding as of beginning of period	92,642	93,414
Shares issued as part of equity-based compensation plans and the ESPP, net of restricted stock units surrendered for taxes	123	655
Shares repurchased into treasury stock		(1,468)
Shares outstanding as of end of period	92,765	92,601

Table of Contents

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

(12) Stock-Based Compensation

As of September 30, 2009, we had approximately 3,266 shares available for grants of equity awards under our equity-based compensation plans.

Stock Options

A summary of the changes in stock options outstanding under our equity-based compensation plans during 2009 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, 2008	7,378	6.0	\$ 21.03	\$ 21,516
Granted	850		12.23	
Exercised	(23)		5.88	146
Canceled	(115)		22.89	
Options outstanding as of March 31, 2009	8,090	6.0	\$ 20.12	\$ 10,927
Granted	30		12.41	
Exercised	(193)		8.31	1,750
Canceled	(309)		26.10	
Options outstanding as of June 30, 2009	7,618	5.9	\$ 20.14	\$ 18,891
Granted	10		17.82	
Exercised	(89)		11.85	
Canceled	(197)		25.33	
Options outstanding as of September 30, 2009	7,342	5.8	\$ 20.10	\$ 18,650
Options exercisable as of September 30, 2009	4,299	4.2	\$ 18.22	\$ 15,728

The weighted-average grant date fair value of options granted during the three months ended September 30, 2009, June 30, 2009 and March 31, 2009 was \$9.08, \$6.00 and \$5.74, respectively. For the three and nine months ended September 30, 2009, we recognized equity-based compensation expense of approximately \$2,900 and \$10,700, respectively, related to the vesting of stock options and the related tax benefit of approximately \$850 and \$3,140, respectively. 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.

As of September 30, 2009, we had unearned compensation of approximately \$20,200 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)****(12) Stock-Based Compensation (continued)***Restricted Stock Units*

A summary of the changes in RSUs outstanding under our equity-based compensation plans during 2009 is presented below:

	Number of Restricted Stock	Weighted Average Grant Date Fair Value Per Share
Non-vested units as of December 31, 2008	1,673	\$ 28.30
Granted	973	\$ 12.06
Vested	(273)	\$ 28.16
Canceled	(13)	\$ 26.24
Non-vested units as of March 31, 2009	2,360	\$ 21.88
Granted	68	\$ 14.55
Vested	(177)	\$ 29.59
Canceled	(9)	\$ 18.66
Non-vested units as of June 30, 2009	2,242	\$ 21.00
Granted	13	\$ 17.95
Vested	(55)	\$ 31.75
Canceled	(35)	\$ 21.24
Non-vested units as of September 30, 2009	2,165	\$ 20.74

For the three and nine months ended September 30, 2009, we recognized equity-based compensation expense of approximately \$4,300 and \$15,100, respectively, related to the vesting of RSUs and the related tax benefit of approximately \$1,330 and \$4,700, respectively. 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. As of September 30, 2009, we had unearned compensation of approximately \$31,500 relating to RSUs that will be amortized over a weighted-average period of approximately two years.

(13) Financial Information for Guarantor Subsidiaries and Non-Guarantor Subsidiaries

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

We conduct substantially all of our business through our domestic and foreign subsidiaries. SGI's obligations under the Credit Agreement, the 2008 Notes and the 2009 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, 2009 and December 31, 2008 and for the three and nine months ended September 30, 2009 and 2008. 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 2009 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****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET****September 30, 2009**

	Parent Company	SGI	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated
Assets						
Cash and cash equivalents	\$ 133,086	\$ 144	\$	\$ 84,620	\$ (4,772)	\$ 213,078
Accounts receivable, net		83,056	40,970	88,384		212,410
Inventories		31,649	14,784	29,325		75,758
Other current assets	30,818	11,927	8,947	30,182		81,874
Property and equipment, net	2,016	188,281	118,086	256,805		565,188
Investment in subsidiaries	554,868	604,676	7,222	209,699	(1,376,465)	
Goodwill		273,656	74,453	429,431		777,540
Intangible assets		44,321	57,757	11,682		113,760
Intercompany balances	284,661		83,093		367,754	
Other assets	25,989	151,752	13,357	112,060	(6,101)	297,057
Total assets	\$ 1,031,438	\$ 1,389,462	\$ 418,669	\$ 1,252,188	\$ (1,755,092)	\$ 2,336,665
Liabilities and stockholders' equity						
Current installments of long-term debt	\$ 95,752	\$ 5,500	\$	\$ 37,515	\$	\$ 138,767
Current liabilities	41,830	56,494	42,124	82,451	(4,786)	218,113
Long-term debt, excluding current installments	187,075	954,241		48,133		1,189,449
Other non-current liabilities	39,012	9,735	14,884	58,930	6	122,567
Intercompany balances		136,486		231,255	(367,741)	
Stockholders' equity	667,769	227,006	361,661	793,904	(1,382,571)	667,769
Total liabilities and stockholders' equity	\$ 1,031,438	\$ 1,389,462	\$ 418,669	\$ 1,252,188	\$ (1,755,092)	\$ 2,336,665

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

(Unaudited, in thousands, except per share amounts)

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**SUPPLEMENTAL CONDENSED CONSOLIDATING BALANCE SHEET**

December 31, 2008

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Assets						
Cash and cash equivalents	\$ 62,948	\$ 204	\$	\$ 79,016	\$ (1,529)	\$ 140,639
Accounts receivable, net		85,395	45,032	82,060		212,487
Inventories		28,877	16,909	30,010	(425)	75,371
Other current assets	27,063	19,403	7,337	29,478		83,281
Property and equipment, net	2,294	185,560	133,024	255,201	(600)	575,479
Investment in subsidiaries	421,781	278,500	2,264	(931)	(701,614)	
Goodwill		273,656	74,453	309,102		657,211
Intangible assets		44,774	61,036	15,136		120,946
Intercompany balances	562,105				(562,105)	
Other assets	45,266	165,601	15,042	97,230	(6,100)	317,039
Total assets	\$ 1,121,457	\$ 1,081,970	\$ 355,097	\$ 896,302	\$ (1,272,373)	\$ 2,182,453
Liabilities and stockholders equity						
Current installments of long-term debt	\$	\$ 5,500	\$	\$ 37,884	\$	\$ 43,384
Current liabilities	24,537	49,065	48,699	96,534	(1,535)	217,300
Long-term debt, excluding current installments	453,601	740,375		2,107		1,196,083
Other non-current liabilities	47,490	9,971	16,821	55,569	6	129,857
Intercompany balances		239,744	96,393	225,966	(562,103)	
Stockholders equity	595,829	37,315	193,184	478,242	(708,741)	595,829
Total liabilities and stockholders equity	\$ 1,121,457	\$ 1,081,970	\$ 355,097	\$ 896,302	\$ (1,272,373)	\$ 2,182,453

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Three Months Ended September 30, 2009**

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	\$ 96,954	\$ 34,334	\$ 108,864	\$ (1,006)	\$ 239,146
Cost of services and cost of sales (exclusive of depreciation and amortization)		29,301	55,038	54,971	(1,024)	138,286
Selling, general and administrative expenses	12,211	13,014	3,931	9,689	16	38,861
Depreciation and amortization	172	9,347	8,031	14,499		32,049
Operating income	(12,383)	45,292	(32,666)	29,705	2	29,950
Interest expense	5,122	16,231	5	1,378		22,736
Other income	(879)	38,264	(58,879)	6,735	2	(14,757)
Income (loss) before equity in income of subsidiaries, and income taxes	(16,626)	(9,203)	26,208	21,592		21,971
Equity in income of subsidiaries	36,512	25,176			(61,688)	
Income tax expense	4,780	2	4	2,079		6,865
Net income	\$ 15,106	\$ 15,971	\$ 26,204	\$ 19,513	\$ (61,688)	\$ 15,106

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Three Months Ended September 30, 2008**

	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

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

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	7,893	12,082	10	935		20,920
Other income	(18,714)	24,099	(28,446)	8,887		(14,174)
Income (loss) before equity in income of subsidiaries, and income taxes	(4,238)	(9,528)	29,569	16,225		32,028
Equity in income of subsidiaries	26,047	27,516			(53,563)	
Income tax expense	(357)	6,527	116	3,576		9,862
Net income	\$ 22,166	\$ 11,461	\$ 29,453	\$ 12,649	\$ (53,563)	\$ 22,166

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

(Unaudited, in thousands, except per share amounts)

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Nine Months Ended September 30, 2009**

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	\$ 297,829	\$ 97,726	\$ 302,053	\$ (2,744)	\$ 694,864
Cost of services and cost of sales (exclusive of depreciation and amortization)		87,692	165,408	158,242	(2,766)	408,576
Selling, general and administrative expenses	41,250	37,504	11,394	29,303	28	119,479
Employee termination costs	1,346	1,546	433	595		3,920
Depreciation and amortization	517	26,996	24,874	41,066		93,453
Operating income	(43,113)	144,091	(104,383)	72,847	(6)	69,436
Interest expense	19,875	39,530	44	3,491		62,940
Other income	(29,193)	104,124	(133,543)	8,254	(7)	(50,365)
Income (loss) before equity in income of subsidiaries, and income taxes	(33,795)	437	29,116	61,102	1	56,861
Equity in income (loss) of subsidiaries	86,889	44,234			(131,123)	
Income tax expense	42,832	(14)	126	3,655		46,599
Net income	\$ 10,262	\$ 44,685	\$ 28,990	\$ 57,447	\$ (131,122)	\$ 10,262

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF INCOME****Nine Months Ended September 30, 2008**

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Operating revenues	\$	\$ 386,155	\$ 121,816	\$ 350,167	\$ (3,227)	\$ 854,911
		221,873	80,730	204,816	(3,217)	504,202

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Cost of services and cost of sales (exclusive of depreciation and amortization)

Selling, general and administrative expenses	45,884	42,424	12,675	37,070	(50)	138,003
Employee termination costs		2,772				2,772
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	38,631	15,169	40	1,905		55,745
Other income	(31,525)	62,651	(85,429)	7,098	40	(47,165)
Income (loss) before equity in income of subsidiaries, and income taxes	(53,822)	3,106	90,192	55,779		95,255
Equity in income of subsidiaries		132,308	85,057		(217,365)	
Income tax expense		13,903	9,637	410	6,722	30,672
Net income	\$ 64,583	\$ 78,526	\$ 89,782	\$ 49,057	\$ (217,365)	\$ 64,583

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

(Unaudited, in thousands, except per share amounts)

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES**SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS**

Nine Months Ended September 30, 2009

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Net cash provided by operating activities	\$ (28,988)	\$ 54,155	\$ 73,462	\$ 77,365	\$	\$ 175,994
Cash flows from investing activities:						
Capital and wagering systems expenditures		(22,016)	(5,384)	(26,605)		(54,005)
Business acquisitions, net of cash acquired			(897)	(88,556)		(89,453)
Other assets and investments	86	(143,961)	(12,461)	(239,747)	373,654	(22,429)
Net cash provided by (used in) investing activities	86	(165,977)	(18,742)	(354,908)	373,654	(165,887)
Cash flows from financing activities:						
Net proceeds (payments) on long-term debt	(179,125)	213,726		41,425		76,026
Net proceeds from stock issue	2,191	(3,074)	139,989	236,739	(373,654)	2,191
Purchase of treasury stock	(5,539)					(5,539)
Payment of financing fees		(11,535)				(11,535)
Other, principally intercompany balances	281,515	(87,355)	(197,950)	3,790		
Net cash provided by (used in) financing activities	99,042	111,762	(57,961)	281,954	(373,654)	61,143
Effect of exchange rate changes on cash				1,189		1,189
Increase (decrease) in cash and cash equivalents	70,140	(60)	(3,241)	5,600		72,439
Cash and cash equivalents, beginning of period	62,949	204	(1,528)	79,014		140,639
Cash and cash equivalents, end of period	\$ 133,089	\$ 144	\$ (4,769)	\$ 84,614	\$	\$ 213,078

Table of Contents**SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited, in thousands, except per share amounts)****SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS****Nine months Ended September 30, 2008**

	Parent Company	SGI	Guarantor Subsidiaries	Non- Guarantor Subsidiaries	Eliminating Entries	Consolidated
Net cash provided by operating activities	\$ (22,013)	\$ (7,995)	\$ 121,552	\$ 56,118	\$ (6,217)	\$ 141,445
Cash flows from investing activities:						
Capital and wagering systems expenditures	(690)	(32,490)	(9,233)	(87,800)		(130,213)
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)	(50,217)	(103,359)	21,639	(168,924)
Cash flows from financing activities:						
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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited, in thousands, except per share amounts)

SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

SUPPLEMENTAL CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

Nine months Ended September 30, 2008

(14) Subsequent Events

On October 13, 2009, the Company and SGI entered into a third amendment (the "Third Amendment") to the Credit Agreement. Under the Third Amendment, solely for purposes of determining whether the Company or SGI may incur Permitted Additional Subordinated Debt or Permitted Additional Senior Indebtedness at any time prior to December 31, 2009, the required Consolidated Leverage Ratio, Consolidated Senior Debt Ratio and Consolidated Interest Coverage Ratio will be deemed to be the same as those required for December 31, 2009.

On October 29, 2009, SGI entered into a commitment letter with J.P. Morgan Securities and JPMorgan, pursuant to which JPMorgan has committed, subject to certain conditions, to provide up to \$75,000 in the aggregate of senior secured term loans under one or more incremental term loan facilities pursuant to SGI's existing credit facilities.

Any proceeds from borrowings under these incremental term loan facilities would be available to be applied for general corporate purposes, which may include the payment of a portion of potential obligations in connection with any award of a new Italian instant ticket lottery concession (including potential upfront payment obligations), the funding of any future acquisitions, capital expenditures and the repayment or repurchase, through open market purchases or otherwise, of a portion of the outstanding indebtedness of the Company or its subsidiaries.

SGI is not obligated to utilize this commitment or to borrow any amounts thereunder. This commitment is subject to certain conditions and will expire on June 30, 2010. While SGI currently believes it will be able to satisfy the conditions to borrowing provided for under the commitment, there can be no assurance that it will be able to do so.

On November 5, 2009, SGI issued an additional \$125,000 aggregate principal amount of its 2009 Notes at an issue price of 101.5% of the principal amount of the notes. The additional 2009 Notes were issued pursuant to the 2009 Notes Indenture and are equal in right of payment with, of the same series as, and vote as a single class on any matter submitted to the holders of, the 2009 Notes issued in May 2009. See Note 6 of the Notes to Consolidated Financial Statements for additional information regarding the notes issued pursuant to the 2009 Notes Indenture. The additional 2009 Notes were issued in a private offering to qualified institutional buyers in accordance with Rule 144A and to persons outside the United States under Regulation S under the Securities Act.

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, 2009, 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, 2008 included in our Current Report on Form 8-K filed on May 18, 2009.

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 the size of the jackpots of lottery games such as Powerball® and Mega Millions during the relevant period. In addition, Printed Products sales may vary depending on the season and timing of contract awards, changes in customer budgets, changes in the way that we price our contracts, inventory ticket levels, lottery retail sales and general economic conditions.

Background

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

We operate 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 lottery 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 access to a licensed property portfolio, including Deal or No Deal, Major League Baseball®, National Basketball Association, Harley-Davidson®, Wheel-of-Fortune®, Monopoly, Corvette® and World Poker Tour®. This division also includes promotional instant tickets and pull-tab tickets that we sell to both lottery and non-lottery customers.

We are a manufacturer of prepaid phone cards, which entitle cellular phone users to a pre-specified 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 same secure process that we employ in the production of instant lottery tickets.

In 2007, we entered into an arrangement to sell instant lottery tickets directly to the China Sports Lottery between March and December in 2008. During 2008, we recorded approximately \$40.2 million in revenues from the China Sports Lottery as a result of this temporary arrangement. Beginning in 2009, the China Sports Lottery began purchasing instant lottery tickets through our joint venture, CSG Lottery Technology (Beijing) Co. Ltd., (CSG), in which we have a 49% interest.

Lottery Systems Group

Our lottery systems business includes the supply of transaction processing software for the accounting and validation of instant ticket and online 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 the operation of credit card processing systems.

Diversified Gaming Group

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, 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. 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 to U.K. pub operators; and our pari-mutuel gaming operations in Connecticut, Maine and the Netherlands.

Table of Contents

Results of Operations

Three Months Ended September 30, 2009 Compared to Three Months Ended September 30, 2008

The following analysis compares the results of operations for the quarter ended September 30, 2009 to the results of operations for the quarter ended September 30, 2008.

Overview

Revenue Analysis

For the quarter ended September 30, 2009, total revenue was \$239.1 million compared to \$291.9 million for the quarter ended September 30, 2008, a decrease of \$52.8 million or 18%. Our service revenue for the quarter ended September 30, 2009 was \$222.0 million compared to \$265.4 million for the quarter ended September 30, 2008, a decrease of \$43.4 million, or 16%. The decrease was primarily attributable to instant lottery tickets now being sold in China by our joint venture rather than by us directly (\$12.8 million), the impact of revised terms of previously announced lottery contract awards (\$11.9 million), the loss of the South Carolina, West Virginia and South Dakota online lottery contracts (\$3.5 million), a decrease in our licensed property revenues (\$6.2 million), decreased sales of instant lottery tickets internationally and domestically (\$3.9 million), lower dollars wagered, or handle, in our pari-mutuel business (\$2.2 million) and the negative impact of foreign exchange rates (\$7.8 million), partially offset by an increase in the sale of instant lottery tickets in Italy and the United Kingdom (\$3.7 million) and increased service revenue from Global Draw and Games Media (\$3.3 million).

Our sales revenue for the quarter ended September 30, 2009 was \$17.1 million compared to \$26.5 million for the quarter ended September 30, 2008, a decrease of \$9.4 million or 35%. The decrease was primarily due to lower phone card sales revenue in the quarter (\$4.3 million), lower hardware and software sales in Lottery Systems and Diversified Gaming (\$6.4 million) and the negative impact of foreign exchange rates.

Expense Analysis

Cost of services of \$127.8 million for the quarter ended September 30, 2009 was \$29.7 million or 19% lower than for the quarter ended September 30, 2008. The decrease was primarily due to instant lottery tickets now being produced in China by our joint venture rather than by us directly (\$12.2 million), lower costs associated with our licensed properties business (\$5.2 million), savings related to the Company's Profitability Improvement Program (\$4.4 million), our exit from the Mexico online lottery contract (\$2.3 million), the loss of our South Carolina, West Virginia and South Dakota online lottery contracts (\$2.5 million), lower costs associated with decreased revenue from our pari-mutuel and venue management business (\$1.6 million) and the impact of foreign exchange rates (\$4.3 million).

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Cost of sales of \$10.5 million for the quarter ended September 30, 2009 was \$6.8 million or 39% lower than for the quarter ended September 30, 2008 primarily due to lower costs in our phone card business as a result of lower sales in the quarter and lower costs associated with decreased Lottery Systems and Diversified Gaming hardware and software sales.

Selling, general and administrative expense of \$38.9 million for the quarter ended September 30, 2009 was \$3.0 million or 7% lower than for the quarter ended September 30, 2008. The decrease was primarily attributable to reduced incentive compensation costs, savings realized from our Profitability Improvement Program (\$2.5 million) and the favorable impact of foreign exchange rates.

Depreciation and amortization expense of \$32.0 million for the quarter ended September 30, 2009 decreased \$4.5 million or 12% from the quarter ended September 30, 2008 primarily due to decreased depreciation and amortization on our new Pennsylvania online lottery contract and decreased depreciation and amortization from the Mexico, Oklahoma, South Carolina, West Virginia and South Dakota online lottery contracts, partially offset by increased depreciation from our domestic pari-mutuel business.

Interest expense of \$22.7 million for the quarter ended September 30, 2009 increased \$1.8 million or 9% from the quarter ended September 30, 2008, primarily attributable to increased borrowings from the issuance of the 2009 Notes, partially offset by decreased borrowings from the repurchase of debt during the third quarter of 2009 and a decline in LIBOR rates.

Equity in earnings of joint ventures primarily reflects our share of the earnings of CLN in connection with the operation of the Italian Gratta e Vinci instant lottery, our share of the earnings of CSG, our share of the earnings of Roberts Communications Network, LLC (RCN) and our interest in Guard Libang. For the quarter ended September 30, 2009, our share of CLN's income totaled \$11.2 million compared to \$12.0 million in the quarter ended September 30, 2008. The decrease in income for the quarter ended September 30, 2009 primarily reflects the negative impact of foreign exchange rates and lower retail sales. For the quarter ended September 30, 2009 our share of the earnings of CSG was \$1.5 million; there was no comparable amount in 2008. For the quarters ended September 30, 2009 and 2008, our share of the earnings of RCN was \$0.9 million and \$1.0 million, respectively. For the quarters ended September 30, 2009 and 2008, our share of

Table of Contents

the earnings of Guard Libang was \$0.6 million and \$0.5 million respectively.

Income tax expense was \$6.9 million for the quarter ended September 30, 2009 compared to \$9.9 million for the quarter ended September 30, 2008. The effective income tax rates for the quarters ended September 30, 2009 and 2008 were 31.2% and 30.8%, respectively. The effective tax rate for the three months ended September 30, 2009 includes the impact of the release of certain FIN 48 reserves associated with tax settlements in the quarter. The effective tax rate for the quarter ended September 30, 2008 was less than the U.S. federal statutory rate of 35% due to lower tax rates applicable to earnings on operations outside the United States.

Segment Overview

Printed Products

For the quarter ended September 30, 2009, total revenue for Printed Products was \$120.8 million compared to \$154.6 million for the quarter ended September 30, 2008, a decrease of \$33.8 million or 22%. For the quarter ended September 30, 2009, service revenue for Printed Products was \$117.7 million compared to \$147.1 million in the corresponding period in the prior year, a decrease of \$29.4 million or 20%. The decrease was primarily attributable to instant lottery tickets now being sold in China by our joint venture rather than by us directly (\$12.8 million), the impact of the revised terms of previously announced lottery contract awards (\$5.4 million), the loss of our cooperative services contract with Ohio, decreased licensed property revenues (\$6.2 million), decreased sales of instant lottery tickets internationally and domestically (\$3.9 million) and the negative impact of foreign exchange rates (\$2.8 million). The decrease was partially offset by an increase in the sale of instant lottery tickets in Italy and the United Kingdom (\$3.7 million).

Printed Products sales revenue for the quarter ended September 30, 2009 was \$3.0 million compared to \$7.4 million for the quarter ended September 30, 2008, a decrease of \$4.4 million or 59%. The decrease was primarily the result of lower phone card sales revenue in the quarter (\$4.3 million).

Cost of services of \$69.9 million for the quarter ended September 30, 2009 was \$21.6 million or 24% lower than for the quarter ended September 30, 2008. The decrease was primarily due to instant lottery tickets now being produced in China by our joint venture rather than by us directly (\$12.2 million), lower costs associated with our licensed properties business (\$5.2 million), the loss of our cooperative services contract with Ohio, lower costs associated with the decreased sales of instant lottery tickets, savings related to the Company's Profitability Improvement Program and the impact of foreign exchange rates (\$2.5 million).

Cost of sales of \$2.2 million for the quarter ended September 30, 2009 was \$2.2 million or 50% lower than for the quarter ended September 30, 2008 primarily due to lower costs in our phone card business as a result of lower sales in the quarter.

Selling, general and administrative expense of \$11.8 million for the quarter ended September 30, 2009 was \$2.5 million or 17% lower than for the quarter ended September 30, 2008. The decrease was primarily attributable to reduced incentive compensation costs, savings realized from our Profitability Improvement Program (\$0.9 million) and the impact of foreign exchange rates.

Depreciation and amortization expense of \$8.2 million for the quarter ended September 30, 2009 decreased \$1.1 million or 12% compared to the quarter ended September 30, 2008, primarily due to reduced depreciation and amortization from our domestic and international contracts.

Lottery Systems

For the quarter ended September 30, 2009, total revenue for Lottery Systems was \$65.5 million compared to \$77.4 million for the quarter ended September 30, 2008, a decrease of \$11.9 million or 15%. Lottery Systems service revenue for the quarter ended September 30, 2009 was \$52.3 million compared to \$62.4 million for the quarter ended September 30, 2008, a decrease of \$10.1 million or 16%. The decrease was primarily due to the revised terms of our online lottery contracts (\$6.5 million), the loss of the South Carolina, West Virginia and South Dakota online lottery contracts (\$3.5 million) and the impact of foreign exchange rates.

Lottery Systems sales revenue for the quarter ended September 30, 2009 was \$13.1 million compared to \$15.1 million for the

Table of Contents

quarter ended September 30, 2008, a decrease of \$2.0 million or 13%. The decrease was primarily due to lower sales of Lottery Systems hardware and software in 2009 (\$4.3 million), partially offset by increased sales of lottery terminals to Italy (\$3.3 million).

Cost of services of \$26.7 million for the quarter ended September 30, 2009 was \$5.9 million or 18% lower than for the quarter ended September 30, 2008. The decrease was primarily due to our exit from the Mexico online lottery contract (\$2.3 million) and the loss of our South Carolina, West Virginia and South Dakota online lottery contracts (\$2.5 million).

Cost of sales of \$7.7 million for the quarter ended September 30, 2009 was \$3.9 million or 34% lower than for the quarter ended September 30, 2008, primarily due to fewer lottery hardware and software sales in 2009.

Selling, general and administrative expense of \$8.2 million for the quarter ended September 30, 2009 was \$1.3 million or 19% higher than for the quarter ended September 30, 2008. The increase was primarily attributable to a favorable adjustment made to internal labor allocation rates in 2008 and increased hardware engineering expenses, partially offset by reduced incentive compensation costs and savings realized from our Profitability Improvement Program.

Depreciation and amortization expense of \$11.5 million for the quarter ended September 30, 2009 decreased \$3.9 million or 25% compared to the quarter ended September 30, 2008, primarily due to decreased depreciation and amortization on our new Pennsylvania online lottery contract and decreased depreciation and amortization from the Mexico, Oklahoma, South Carolina, West Virginia and South Dakota online lottery contracts.

Diversified Gaming

For the quarter ended September 30, 2009, total revenue for Diversified Gaming was \$52.9 million compared to \$59.9 million for the quarter ended September 30, 2008, a decrease of \$7.0 million or 12%. Diversified Gaming service revenue for the three months ended September 30, 2009 was \$51.9 million compared to \$55.9 million for the quarter ended September 30, 2008, a decrease of \$4.0 million or 7%. The decrease in service revenue was primarily due to lower handle in our pari-mutuel and venue management business (\$2.2 million) and the negative impact of foreign exchange rates, partially offset by increased service revenue from Global Draw and Games Media (\$3.3 million).

Diversified Gaming sales revenue for the quarter ended September 30, 2009 was \$0.9 million compared to \$4.0 million for the quarter ended September 30, 2008, a decrease of \$3.1 million or 78%. 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 (\$0.2 million), lower sales from Global Draw (\$2.3 million) and the negative impact of foreign exchange rates.

Cost of services of \$31.1 million for the quarter ended September 30, 2009 was \$2.3 million or 7% lower than for the quarter ended September 30, 2008. The decrease was primarily due to lower costs associated with decreased revenue from our pari-mutuel and venue management business (\$1.6 million), lower costs from Global Draw and the impact of foreign exchange rates (\$1.5 million), partially offset by costs from increased service revenue from Games Media.

Cost of sales of \$0.6 million for the quarter ended September 30, 2009 was \$0.7 million or 54% lower than for the quarter ended September 30, 2008, primarily due to reduced sales from Games Media and Global Draw.

Selling, general and administrative expense of \$5.6 million for the quarter ended September 30, 2009 was \$0.2 million or 4% higher than for the quarter ended September 30, 2008. The increase was primarily due to increased costs from Global Draw and from our domestic pari-mutuel business, partially offset by lower costs from Games Media.

Depreciation and amortization expense of \$12.2 million for the quarter ended September 30, 2009 increased \$0.7 million or 6% from the quarter ended September 30, 2008, primarily due to increased depreciation from Games Media and from our domestic pari-mutuel business.

Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008

The following analysis compares the results of operations for the nine months ended September 30, 2009 to the results of operations for the nine months ended September 30, 2008.

Table of Contents

Overview

Revenue Analysis

For the nine months ended September 30, 2009, total revenue was \$694.9 million compared to \$854.9 million for the nine months ended September 30, 2008, a decrease of \$160.0 million or 19%. Our service revenue for the nine months ended September 30, 2009 was \$650.6 million compared to \$764.0 million for the nine months ended September 30, 2008, a decrease of \$113.4 million, or 15%. The decrease was primarily attributable to instant lottery tickets now being sold in China by our joint venture rather than by us directly (\$25.2 million), the revised terms of previously announced lottery contract awards (\$43.8 million), the loss of the South Carolina, West Virginia and South Dakota online lottery contracts, decreased licensed property revenues (\$15.5 million), lower handle in our pari-mutuel and venue management business (\$8.9 million) and the negative impact of foreign exchange rates (\$31.6 million). The decrease was partially offset by increased revenue from instant ticket validation services in China (\$7.8 million) and increased service revenue from Global Draw and Games Media (\$13.1 million).

Our sales revenue for the nine months ended September 30, 2009 was \$44.2 million compared to \$90.9 million for the nine months ended September 30, 2008, a decrease of \$46.7 million or 51%. The decrease was primarily the result of lower phone card sales revenue (\$12.9 million), decreased Lottery Systems and Diversified Gaming hardware and software sales in 2009 (\$29.5 million) and the negative impact of foreign exchange rates (\$7.7 million).

Expense Analysis

Cost of services of \$377.7 million for the nine months ended September 30, 2009 was \$62.7 million or 14% lower than for the nine months ended September 30, 2008. The decrease was primarily due to instant lottery tickets now being produced in China by our joint venture rather than by us directly (\$23.2 million), lower costs associated with our licensed properties (\$8.2 million), savings related to the Company's Profitability Improvement Program (\$11.4 million), the loss of our South Carolina, West Virginia and South Dakota online lottery contracts (\$2.5 million), decreased costs from the Mexico online contract (\$6.2 million), lower costs associated with decreased revenue from our pari-mutuel and venue management business (\$5.9 million) and the impact of foreign exchange rates, partially offset by increased costs related to China (\$1.9 million) and increased costs associated with increased service revenue from Global Draw and Games Media (\$5.1 million).

Cost of sales of \$30.9 million for the nine months ended September 30, 2009 was \$32.9 million or 52% lower than for the nine months ended September 30, 2008 primarily due to lower costs in our phone card business as a result of lower sales revenue, fewer Lottery Systems hardware and software sales, reduced sales from Games Media and Global Draw and the impact of foreign exchange rates.

Selling, general and administrative expense of \$119.5 million for the nine months ended September 30, 2009 was \$18.5 million or 13% lower than for the nine months ended September 30, 2008. The decrease was primarily attributable to reduced incentive compensation costs (\$6.2 million), savings realized from our Profitability Improvement Program (\$6.8 million) and the favorable impact of foreign exchange rates offset by costs associated with a property tax settlement.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Employee termination costs of \$3.9 million for the nine months ended September 30, 2009 were a result of our cost reduction initiatives. Employee termination costs of \$2.8 million for the nine months ended September 30, 2008 were a result of the restructuring of our phone card business in the U.K.

Depreciation and amortization expense of \$93.5 million for the nine months ended September 30, 2009 decreased \$12.6 million or 12% from the nine months ended September 30, 2008 primarily due to decreased depreciation and amortization on our new Pennsylvania online lottery contract and decreased depreciation and amortization from the Oklahoma and Mexico online lottery contracts, partially offset by increased depreciation from Global Draw, Games Media and our domestic pari-mutuel business.

Interest expense of \$62.9 million for the nine months ended September 30, 2009 increased \$7.2 million or 13% from the nine months ended September 30, 2008, primarily attributable to increased borrowings from the 2009 Notes and the June 2008 debt refinancing, partially offset by decreased borrowings from the repurchase of debt during 2009 and a decline in LIBOR rates.

Equity in earnings of joint ventures primarily reflects our share of the earnings from the CLN, our share of the earnings from CSG, our share of the earnings of RCN and our interest in Guard Libang. For the nine months ended September 30, 2009, our share of CLN's income totaled \$37.8 million compared to \$43.0 million in the nine months ended September 30, 2008. The decrease in income for the nine months ended September 30, 2009 primarily reflects the negative impact of foreign exchange rates. For the nine months ended September 30, 2009 and 2008, our share of the earnings of CSG was \$2.9 million and \$0.0 million respectively. For the nine months ended September 30, 2009 and 2008, our share of the earnings of RCN was \$2.2 million and \$2.9 million, respectively. For the nine months ended September 30, 2009 and 2008, our share of the earnings of Guard Libang was \$2.3 million and \$2.8 million respectively.

Table of Contents

Income tax expense was \$46.6 million for the nine months ended September 30, 2009 compared to \$30.7 million for the nine months ended September 30, 2008. The effective income tax rates for the nine months ended September 30, 2009 and 2008 were 82.0% and 32.2%, respectively. The effective rate for the nine months ended September 30, 2009 includes the impact of a valuation allowance against the deferred tax asset related to foreign tax credits. The effective tax rate for the nine months ended September 30, 2008 was less than the U.S. federal statutory rate of 35% due to lower tax rates applicable to earnings on operations outside the United States.

Segment Overview

Printed Products

For the nine months ended September 30, 2009, total revenue for Printed Products was \$350.4 million compared to \$445.8 million for the nine months ended September 30, 2008, a decrease of \$95.4 million or 21%. For the nine months ended September 30, 2009, service revenue for Printed Products was \$340.6 million compared to \$421.2 million in the corresponding period in the prior year, a decrease of \$80.6 million or 19%. The decrease was primarily attributable to instant lottery tickets now being sold in China by our joint venture rather than by us directly (\$25.2 million), the impact of the revised terms of previously announced lottery contract awards (\$25.1 million), decreased licensed property revenues (\$15.5 million) and the negative impact of foreign exchange rates (\$12.4 million), partially offset by an increase in the sale of instant lottery tickets in Italy and the United Kingdom (\$3.7 million).

Printed Products sales revenue for the nine months ended September 30, 2009 was \$9.8 million compared to \$24.6 million for the nine months ended September 30, 2008, a decrease of \$14.8 million or 60%. The decrease was primarily the result of lower phone card sales revenue (\$12.9 million) and decreased sales in Germany due to the closing of the Honsel facility in the first quarter of 2008 (\$1.3 million).

Cost of services of \$202.6 million for the nine months ended September 30, 2009 was \$47.1 million or 19% lower than for the nine months ended September 30, 2008. The decrease was primarily due to instant lottery tickets now being produced in China by our joint venture rather than by us directly (\$23.2 million), lower costs associated with our licensed properties (\$8.2 million), savings related to the Company's Profitability Improvement Program and the impact of foreign exchange rates.

Cost of sales of \$6.7 million for the nine months ended September 30, 2009 was \$9.6 million or 59% lower than for the nine months ended September 30, 2008 primarily due to lower costs in our phone card business as a result of lower sales, the decline of sales in Germany and the impact of foreign exchange rates.

Selling, general and administrative expense of \$34.1 million for the nine months ended September 30, 2009 was \$11.0 million or 24% lower than for the nine months ended September 30, 2008. The decrease was primarily attributable to reduced incentive compensation costs, savings realized from our Profitability Improvement Program and the impact of foreign exchange rates.

Employee termination costs of \$2.0 million for the nine months ended September 30, 2009 were a result of our cost reduction initiatives. Employee termination costs of \$2.8 million for the nine months ended September 30, 2008 were a result of our restructuring of phone card

manufacturing in the U.K.

Depreciation and amortization expense of \$24.1 million for the nine months ended September 30, 2009 decreased \$4.6 million or 16% compared to the nine months ended September 30, 2008, primarily due to reduced depreciation and amortization from our domestic and international contracts.

Lottery Systems

For the nine months ended September 30, 2009, total revenue for Lottery Systems was \$190.5 million compared to \$225.7 million for the nine months ended September 30, 2008, a decrease of \$35.2 million or 16%. Lottery Systems service revenue for the nine months ended September 30, 2009 was \$159.4 million compared to \$178.3 million for the nine months ended September 30, 2008, a decrease of \$18.9 million or 11%. The decrease was primarily due to the revised terms of our online lottery contracts (\$19.8 million), the loss of the South Carolina, West Virginia and South Dakota online lottery contracts (\$6.2 million) and the negative impact of foreign exchange rates (\$2.4 million), partially offset by increased revenue from instant ticket validation services in China (\$7.8 million) and the improved rate on the Puerto Rico online contract.

Lottery Systems sales revenue for the nine months ended September 30, 2009 was \$31.1 million compared to \$47.3 million for the nine months ended September 30, 2008, a decrease of \$16.2 million or 34%. The decrease was primarily due to decreased Lottery Systems hardware and software sales in 2009 (\$16.5 million) and the negative impact of foreign exchange rates (\$3.4 million), partially offset by increased terminal sales to Italy.

Cost of services of \$83.5 million for the nine months ended September 30, 2009 was \$8.9 million or 10% lower than for the

Table of Contents

nine months ended September 30, 2008. The decrease was primarily due to decreased costs from the Mexico online lottery contract (\$6.2 million) and the loss of our South Carolina, West Virginia, and South Dakota online lottery contracts (\$4.2 million), partially offset by increased costs associated with the new Connecticut online contract (\$1.8 million) and increased costs related to China.

Cost of sales of \$22.0 million for the nine months ended September 30, 2009 was \$16.4 million or 43% lower than for the nine months ended September 30, 2008, primarily due to fewer Lottery Systems hardware and software sales in 2009 and the impact of foreign exchange rates, partially offset by increased costs from terminal sales to Italy.

Selling, general and administrative expense of \$23.0 million for the nine months ended September 30, 2009 was \$2.7 million or 11% lower than for the nine months ended September 30, 2008. The decrease was primarily attributable to reduced incentive compensation costs and savings realized from our Profitability Improvement Program (\$2.8 million).

Employee termination costs of \$0.1 million for the nine months ended September 30, 2009 were a result of our cost reduction initiatives.

Depreciation and amortization expense of \$32.9 million for the nine months ended September 30, 2009 decreased \$12.9 million or 28% compared to the nine months ended September 30, 2008, primarily due to decreased depreciation and amortization on our new Pennsylvania online lottery contract and decreased depreciation and amortization from the Mexico and Oklahoma online lottery contracts.

Diversified Gaming

For the nine months ended September 30, 2009, total revenue for Diversified Gaming was \$154.0 million compared to \$183.4 million for the nine months ended September 30, 2008, a decrease of \$29.4 million or 16%. Diversified Gaming service revenue for the nine months ended September 30, 2009 was \$150.6 million compared to \$164.6 million for the nine months ended September 30, 2008, a decrease of \$14.0 million or 9%. The decrease in service revenue was primarily due to lower handle in our pari-mutuel and venue management business (\$8.9 million) and the negative impact of foreign exchange rates (\$16.9 million), partially offset by increased service revenue from Global Draw and Games Media (\$13.1 million).

Diversified Gaming sales revenue for the nine months ended September 30, 2009 was \$3.4 million compared to \$18.9 million for the nine months ended September 30, 2008, a decrease of \$15.5 million or 82%. The decrease was primarily due to the absence of a Global Draw content sale from 2008 (\$2.4 million), 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 (\$6.3 million), which are being deployed under revenue participation agreements, lower sales from Global Draw, the negative impact of foreign exchange rates (\$3.8 million) and a one-time sale of pari-mutuel terminals in 2008 (\$1.1 million).

Cost of services of \$91.6 million for the nine months ended September 30, 2009 was \$6.7 million or 7% lower than for the nine months ended September 30, 2008. The decrease was primarily due to lower costs associated with decreased revenue from our pari-mutuel and venue management business (\$5.9 million) and the impact of foreign exchange rates (\$7.0 million), partially offset by increased costs associated with

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

increased service revenue from Global Draw and Games Media (\$7.9 million).

Cost of sales of \$2.1 million for the nine months ended September 30, 2009 was \$7.0 million or 77% lower than for the nine months ended September 30, 2008, primarily due to reduced sales from Games Media and Global Draw.

Selling, general and administrative expense of \$17.3 million for the nine months ended September 30, 2009 was \$2.2 million or 11% lower than for the nine months ended September 30, 2008 (\$3.4 million). The decrease was primarily due to the absence of the Global Draw employee earn-out bonus which was accrued in part in the nine months ended September 30, 2008 and lower costs from Games Media and our domestic pari-mutuel business, partially offset by an increase in costs from Global Draw and costs associated with a property tax settlement.

Employee termination costs of \$0.4 million for the nine months ended September 30, 2009 were a result of our cost reduction initiatives.

Depreciation and amortization expense of \$36.0 million for the nine months ended September 30, 2009 increased \$5.2 million or 17% from the nine months ended September 30, 2008, primarily due to increased depreciation from Global Draw, Games Media and 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 Current Report on Form 8-K filed on May 18, 2009.

Table of Contents

Liquidity, Capital Resources and Working Capital

On May 21, 2009, Scientific Games International, Inc. (SGI) issued \$225.0 million in aggregate principal amount of its 9.25% Senior Subordinated Notes due 2019 (the 2009 Notes) at an issue price of 96.823% of the principal amount. The 2009 Notes were issued pursuant to an indenture dated as of May 21, 2009 (the 2009 Notes Indenture) among SGI, as issuer, the Company, as a guarantor, the Company's subsidiary guarantors party thereto and The Bank of Nova Scotia Trust Company of New York, as trustee.

The 2009 Notes bear interest at the rate of 9.25% per annum, which accrues from May 21, 2009 and is payable semiannually in arrears on June 15 and December 15 of each year, commencing on December 15, 2009. The 2009 Notes mature on June 15, 2019, unless earlier redeemed or repurchased, and are subject to the terms and conditions set forth in the 2009 Notes Indenture.

SGI may redeem some or all of the 2009 Notes at any time prior to June 15, 2014 at a price equal to 100% of the principal amount of the 2009 Notes plus accrued and unpaid interest, if any, to the date of redemption plus a make whole premium. SGI may redeem some or all of the 2009 Notes for cash at any time on or after June 15, 2014 at the prices specified in the 2009 Notes Indenture. In addition, at any time on or prior to June 15, 2012, SGI may redeem up to 35% of the initially outstanding aggregate principal amount of the 2009 Notes at a redemption price of 109.25% 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 the 2009 Notes is required to be licensed, qualified or found suitable under any applicable gaming laws or regulations and that holder does not become so licensed or qualified or is not found to be suitable, then SGI will have the right to, subject to certain notice provisions set forth in the 2009 Notes Indenture, (1) require that holder to dispose of all or a portion of those Notes or (2) redeem the 2009 Notes of that holder at a redemption price calculated as set forth in the 2009 Notes Indenture. If the Company or SGI experiences specific kinds of changes in control or the Company or any of its restricted subsidiaries sells certain of its assets, then SGI must offer to repurchase the 2009 Notes on the terms set forth in the 2009 Notes Indenture.

The 2009 Notes are unsecured senior subordinated obligations of SGI and 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 2009 Notes. The 2009 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The 2009 Notes are guaranteed on an unsecured senior subordinated basis by the Company and all of its 100%-owned domestic subsidiaries (other than SGI). The guarantees of the 2009 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 2009 Notes. The 2009 Notes are structurally subordinated to all of the liabilities of the Company's non-guarantor subsidiaries.

The 2009 Notes 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 assets 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 2009 Notes Indenture contains events of default customary for agreements of its type (with customary grace periods, as applicable) and provides that, upon the occurrence of an event of default arising from certain events of bankruptcy or insolvency with respect to the Company or

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

SGI, all outstanding Notes will become due and payable immediately without further action or notice. If any other type of event of default occurs and is continuing, then the trustee or the holders of at least 25% in principal amount of the then outstanding Notes may declare all the 2009 Notes to be due and payable immediately.

On November 5, 2009, SGI issued an additional \$125.0 million aggregate principal amount of its 2009 Notes at an issue price of 101.5% of the principal amount of the notes. The additional 2009 Notes were issued pursuant to the 2009 Notes Indenture and are equal in right of payment with, of the same series as, and vote as a single class on any matter submitted to the holders of, the 2009 Notes issued in May 2009.

On May 7, 2009, the Company entered into an agreement with the principal selling shareholder and key management of Global Draw related to the earn-out and contingent bonuses that were payable to them in connection with the Company's 2006 acquisition. Based on the performance of the business, the total amount payable was determined to be approximately £60.6 million, of which approximately £30.5 million was paid in May 2009. Approximately £28.1 million of the total amount payable was deferred under the terms of two-year, senior unsecured promissory notes issued by certain of the Company's foreign subsidiaries (and guaranteed by the Company and certain of its U.S. subsidiaries). The earn-out balance of approximately £2.0 million was paid in September 2009.

The promissory note issued to the principal selling shareholder, which was executed on May 7, 2009 by Scientific Games Luxembourg Finance S.a.r.l. (SGLF), an indirect 100%-owned subsidiary of the Company, has a principal amount of approximately £26 million and bears simple interest at the rate of 6.90% per annum, which interest is payable quarterly in arrears on the last day of March, June, September and December of each year, commencing on June 30, 2009. The note matures on May 7, 2011. Although not required to do so (except in connection with an event of default as described below), SGLF may repay all or a portion of the principal amount of the note at any time prior to maturity without premium or penalty. The note is a senior unsecured obligation of SGLF and is guaranteed on a joint and several basis by the Company and certain of its 100%-owned domestic subsidiaries (including SGI). Such guaranty represents senior debt as that term is defined in the indentures governing the Company's 6.25% Senior Subordinated Notes due 2012 (the 2004 Notes), the Convertible Debentures and SGI's 7.875% Senior Subordinated Notes due 2016 and the 2009 Notes.

If an event of default under the note shall occur and be continuing, the holder of the note may declare the principal amount of, and accrued interest on, the note to be immediately due and payable. An event of default under the note shall occur if (1) SGLF shall fail to pay the then unpaid principal amount under the note within 15 days after the maturity date or any interest payment that is due and payable within 15 days after the applicable interest payment date, or (2) an event of default (as defined in the Credit Agreement (as defined below)) shall occur and be continuing and, as a result thereof, the amounts owing under the Credit Agreement immediately become due and

Table of Contents

payable.

The terms of the promissory notes issued to key management of Global Draw and the related guaranties are substantially identical to the note and guaranties described above, except that one of the notes was issued by a different foreign subsidiary of the Company.

On March 27, 2009, we and our 100%-owned subsidiary, SGI, entered into an amendment (the First Amendment) to the credit agreement, dated as of June 9, 2008 (the Credit Agreement), among SGI, as borrower, the Company, as guarantor, the several lenders from time to time parties thereto and JPMorgan Chase Bank, N.A. (JPMorgan), as administrative agent. The purpose of the First Amendment was to provide the Company with additional operating and financing flexibility.

Under the First Amendment, (i) up to approximately \$18.8 million in certain charges incurred and reserves created in the fourth quarter of 2008, (ii) up to \$15.0 million of certain charges that may be incurred during the 12-month period commencing on March 1, 2009, including charges in connection with cost-reduction initiatives, and (iii) certain costs and fees incurred in connection with the First Amendment, will be added back to Consolidated EBITDA for purposes of calculating the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio (as such terms are defined under the Credit Agreement). In addition, for purposes of determining the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio as of any date prior to the earliest date on which any of the holders of Convertible Debentures may require the Company to repurchase their Convertible Debentures (currently June 1, 2010) (the Convertible Debentures Repurchase Date) neither (i) the earn-out payable with respect to the Company's acquisition of Global Draw nor (ii) the principal amount of any unsecured promissory notes that may be issued in order to defer payment of up to the equivalent of \$60.0 million of such earn-out (provided that, among other terms of such promissory notes, no principal payment thereon is required prior to September 30, 2010), will be included as Indebtedness in the calculation of Consolidated Total Debt (as such terms are defined in the Credit Agreement). Accordingly, the promissory notes described above that were issued to the principal selling shareholder and key management of Global Draw will not be included as Indebtedness in the calculation of Consolidated Total Debt for purposes of determining the Consolidated Leverage Ratio and the Consolidated Senior Debt Ratio prior to the Convertible Debenture Repurchase Date.

In conjunction with the promissory notes issued to defer payment of a portion of the Global Draw earn-out, the revolving credit facility and the term loan facility under the Credit Agreement will mature (if earlier than the date that would otherwise apply under the terms of the Credit Agreement) on February 7, 2011 unless on such date no such promissory notes remain outstanding or the sum of the aggregate available revolving commitments under the Credit Agreement plus unrestricted cash and cash equivalents of SGI and the guarantors under the Credit Agreement is not less than \$50.0 million in excess of the amount required to repay in full such outstanding promissory notes.

Under the First Amendment, for purposes of determining the Consolidated Leverage Ratio as of any date of determination prior to the earlier of the Convertible Debentures Repurchase Date and the date the Convertible Debentures are redeemed in full, unrestricted cash and cash equivalents of SGI and the guarantors up to the Debenture Reserve Amount at such determination date will be netted against the then outstanding principal amount of the Convertible Debentures (and Consolidated Total Debt will be thereby reduced to the extent of such netting). The Debenture Reserve Amount is an amount equal to the net cash proceeds received by SGI or the guarantors after the date of the First Amendment and prior to the Convertible Debentures Repurchase Date from (i) the issuance by the Company of shares of its capital stock (other than disqualified stock), or the issuance of Permitted Additional Senior Indebtedness or Permitted Additional Subordinated Debt or Indebtedness under the Incremental Facilities (as such terms are defined in the Credit Agreement), and (ii) any Asset Sales (as defined in the Credit Agreement) (up to an aggregate of \$125.0 million of net cash proceeds) with respect to which a reinvestment notice is timely given (provided that the Debenture Reserve Amount will (A) not exceed the outstanding principal amount of the Convertible Debentures, (B) be reduced to zero on the Convertible Debentures Repurchase Date and (C) to the extent the Debenture Reserve Amount is increased as a result of Assets Sales, will be decreased if and to the extent that term loans under the Credit Agreement are prepaid in lieu of reinvesting the net cash proceeds therefrom pursuant to a reinvestment notice). The 2009 Notes constitute Permitted Additional Subordinated Debt and, as such, the net cash

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

proceeds from the issuance of such notes will be included in the **Debt Reserve Amount** to the extent permitted under the First Amendment.

The First Amendment increased each of the interest rates set forth in the pricing grid in the Credit Agreement by 0.25% such that, depending upon the Consolidated Leverage Ratio, the interest rate will vary from 2.00% to 3.00% above LIBOR for eurocurrency loans, and 1.00% to 2.00% above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50% for base rate loans. Notwithstanding the foregoing, from the Effective Date until September 30, 2009, the applicable margin for eurocurrency loans was deemed to be 3.00% and the applicable margin for base rate loans was deemed to be 2.00%.

In connection with the First Amendment, SGI agreed to pay an aggregate of approximately \$2.8 million in fees to consenting lenders and the administrative agent.

Our Credit Agreement is 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.

On September 30, 2009, the Company and SGI entered into a second amendment (the **Second Amendment**) to the Credit Agreement.

Table of Contents

The primary purpose of the Second Amendment was to facilitate our ability to participate in the recently announced competitive tender process for a license to sell instant lottery tickets under the Gratta e Vinci lottery in Italy. The Second Amendment provides that certain payments, costs and obligations made or incurred by any of the Company or its subsidiaries, whether directly or indirectly, in connection with any award of a license to operate the instant ticket lottery (the Italian Concession), including any up-front fee required under the tender process (collectively,

Italian Concession Obligations), will be permitted, subject to certain limitations, under the Credit Agreement covenant restricting Investments (as defined in the Credit Agreement) (to the extent such Italian Concession Obligations are deemed to be Investments under the Credit Agreement). Certain Guarantee Obligations (as defined in the Credit Agreement) incurred by any of the Company or its subsidiaries in respect of certain Italian Concession Obligations will be permitted under the Credit Agreement covenant restricting Indebtedness. In addition, the Second Amendment provides that certain Italian Concession Obligations paid or incurred in an applicable period will be added back to the definition of Consolidated EBITDA to the extent such Italian Concession Obligations are treated as an expense in the period paid or incurred.

The Second Amendment provides further that, in lieu of any required prepayment of term loans under the Credit Agreement, the net cash proceeds from any Asset Sale or Recovery Event (as defined in the Credit Agreement) may, during the 12-month reinvestment period, be applied to make or incur any Investment to fund or satisfy any Italian Concession Obligations not yet made or satisfied (or, under certain circumstances, may be deemed to apply to any Investment that is made or incurred to fund or satisfy Italian Concession Obligations already funded or satisfied).

In addition, pursuant to the Second Amendment, we will be required to maintain the following revised financial ratios during the following relevant periods:

- a Consolidated Leverage Ratio as at the last day of each fiscal quarter no more than 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 September 30, 2009);

- 4.75 to 1.00 (fiscal quarter ended December 31, 2009 through December 31, 2010);

- 4.50 to 1.00 (fiscal quarter ended March 31, 2011 through December 31, 2011);

- 4.25 to 1.00 (fiscal quarter ended March 31, 2012 through September 30, 2012); and

- 4.00 to 1.00 (fiscal quarter ending December 31, 2012 and thereafter);

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

- a Consolidated Senior Debt Ratio as at the last day of each fiscal quarter no more than the ratio set forth below with respect to such fiscal quarter or with respect to the period during which such fiscal quarter ends:
 - 2.50 to 1.00 (fiscal quarter ended June 30, 2008 through September 30, 2009);
 - 2.75 to 1.00 (fiscal quarter ended December 31, 2009 through December 31, 2010); and
 - 2.50 to 1.00 (fiscal quarter ended March 31, 2011 and thereafter);
- a Consolidated Interest Coverage Ratio (as defined in the Credit Agreement) for any period of four consecutive fiscal quarters of not less than the ratio set forth below with respect to such period or with respect to the period during which such four consecutive fiscal quarters ends:
 - 3.50 to 1.00 (four consecutive fiscal quarters ending on or prior to September 30, 2009); and
 - 3.00 to 1.00 (four consecutive fiscal quarters ending December 31, 2009 and thereafter).

Pursuant to the Second Amendment, certain additional dispositions will be permitted under the Credit Agreement covenant restricting Dispositions, including, subject to certain limitations, dispositions pursuant to certain permitted investments such as permitted investments in Non-Guarantor Subsidiaries, joint ventures and Permitted Acquisitions (as such terms are defined in the Credit Agreement).

Table of Contents

The interest rates set forth in the pricing grid in the Credit Agreement will be unchanged, except that, pursuant to the Second Amendment, an interest rate level will be added to the top of the grid such that, if the Consolidated Leverage Ratio as of the most recent determination date is equal to or greater than 4.25 to 1 (and, in any event, for the six-month period beginning on September 30, 2009), the interest rate will be 3.25% above LIBOR for eurocurrency loans, and 2.25% above the higher of (i) the prime rate or (ii) the Federal Funds Effective Rate plus 0.50% for base rate loans.

The Second Amendment also provides that the commitment fee rate payable in respect of the available revolving credit facility commitments under the Credit Agreement will be (i) 0.50% per annum if the Consolidated Leverage Ratio as of the most recent determination date is less than 4.25 to 1.00 or (ii) 0.75% per annum if the Consolidated Leverage Ratio as of the most recent determination date is greater than or equal to 4.25 to 1.00 (and, in any event, for the six-month period beginning on September 30, 2009).

In connection with the Second Amendment, SGI agreed to pay an aggregate of approximately \$2.8 million in fees to consenting lenders and the administrative agent.

On October 13, 2009, the Company and SGI entered into a third amendment to the Credit Agreement (the Third Amendment). Under the Third Amendment, solely for purposes of determining whether the Company or SGI may incur Permitted Additional Subordinated Debt or Permitted Additional Senior Indebtedness at any time prior to December 31, 2009, the required Consolidated Leverage Ratio, Consolidated Senior Debt Ratio and Consolidated Interest Coverage Ratio will be deemed to be the same as those required for December 31, 2009.

On October 29, 2009, SGI entered into a commitment letter with J.P. Morgan Securities, Inc. and JPMorgan, pursuant to which JPMorgan has committed, subject to certain conditions, to provide up to \$75.0 million in the aggregate of senior secured term loans under one or more incremental term loan facilities under the Credit Agreement.

Any proceeds from borrowings under these incremental term loan facilities would be available to be applied for general corporate purposes, which may include the payment of a portion of potential obligations in connection with any award of a new Italian instant ticket lottery concession (including potential upfront payment obligations), the funding of any future acquisitions, capital expenditures and the repayment or repurchase, through open market purchases or otherwise, of a portion of the outstanding indebtedness of the Company or its subsidiaries.

SGI is not obligated to utilize this commitment or to borrow any amounts thereunder. This commitment is subject to certain conditions and will expire on June 30, 2010. While SGI currently believes it will be able to satisfy the conditions to borrowing provided for under the commitment, there can be no assurance that it will be able to do so.

We were in compliance with our covenants as of September 30, 2009.

As of September 30, 2009, we had approximately \$201.4 million available for additional borrowing or letter of credit issuance under our revolving credit facility. There were no borrowings and \$48.6 million in outstanding letters of credit under our revolving credit facility as of September 30, 2009. 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 our financial ratios or covenants.

The Company may, from time to time, seek to retire or purchase its outstanding debt in open market purchases, in privately negotiated transactions, or otherwise. Any such retirement or purchase of debt may be funded by cash flows from operations, borrowings or other sources and will depend upon prevailing market conditions, liquidity requirements, contractual restrictions and other factors, and the amounts involved may be material. During the three and nine months ended September 30, 2009, we repurchased approximately \$43.2 million and \$174.6 million, respectively, in aggregate principal amount of our Convertible Debentures for approximately \$42.4 million and \$166.4 million, respectively, in cash under our previously announced Convertible Debentures repurchase program. During the nine months ended September 30, 2009, we repurchased approximately \$12.9 million in aggregate principal amount of 2004 Notes for approximately \$12.4 million cash under our previously announced 2004 Notes repurchase program.

During the second and third quarters of 2009, in connection with repurchases made during 2009 under our Convertible Debenture repurchase program, we unwound a corresponding portion of the convertible bond hedge and warrant option transactions that we entered into in December 2004 in connection with the original issuance of the Convertible Debentures such that the number of call options held by us under the bond hedge was reduced from 275,000 to approximately 99,191 and the number of warrants held by the warrant counterparties was reduced from approximately 9,450,171 to approximately 3,408,620. We received a net cash settlement of approximately \$0.1 million and \$1.3 million, respectively, during the three and nine months ended September 30, 2009 as a result of this unwinding of a portion of the convertible bond hedge and warrant option transactions. For additional information on the bond hedge and warrants, refer to Note 8 of the Notes to Consolidated Financial Statements included in our Current Report on Form 8-K filed on May 18, 2009.

On January 1, 2009, we adopted new FASB guidance on accounting for convertible debt instruments that may be settled in cash upon conversion (the New Convertible Debt Guidance). The New Convertible Debt Guidance clarifies that convertible debt instruments that may be settled in cash upon conversion are not addressed by previous convertible debt accounting guidance and 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. The New Convertible Debt Guidance was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years, and was required to be applied retrospectively to all periods presented.

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 as of September 30, 2009:

Table of Contents

	Total	Cash Payments Due By Period			
		In thousands			
		Within 1 Year	Within 2-3 Years	Within 4-5 Years	After 5 Years
Long-term debt, 6.25% notes (1)	\$ 187,075		187,075		
Long-term debt, 0.75% convertible debentures (1) (2)	99,191	99,191			
Long-term debt, 7.875% notes (1)	200,000				200,000
Long-term debt, 9.25% notes (3)	225,000				225,000
Long-term debt, term loan (1)	541,750	5,500	11,000	525,250	
Global Draw promissory note	45,802		45,802		
Unsecured borrowings denominated in RMB (1)	37,478	37,478			
Other long-term debt	2,368	37	1,635	441	255
Interest expense (4)	390,291	74,596	140,072	102,495	73,128
Contractual capital requirements	18,280	18,280			
SERP payout (5)	14,515	8,807	5,708		
Operating leases	91,420	18,324	30,850	24,751	17,495
Other long-term liabilities (6)	22,906		4,794	5,710	12,402
Total contractual obligations	\$ 1,876,076	262,213	426,936	658,647	528,280

(1) Refer to Note 8 of the Notes to Consolidated Financial Statements in our Current Report on Form 8-K filed on May 18, 2009 for information regarding long-term and other debt.

(2) The Convertible Debentures are due in 2024. However, these Convertible Debentures will require cash payment before that date if holders of these Convertible Debentures elect to exercise their right to require us to repurchase their Convertible Debentures or elect to convert the Convertible Debentures, subject to certain conditions, if we call the Convertible Debentures for redemption, or upon certain corporate transactions.

(3) Refer to Note 6 of the Notes to Consolidated Financial Statements for the quarter ended September 30, 2009 for information regarding the 9.25% notes and the Global Draw earn-out promissory notes.

(4) Based on rates in effect at September 30, 2009.

(5) See Note 13 of the Notes to Consolidated Financial Statements in our Current Report on Form 8-K filed on May 18, 2009.

(6) We have excluded approximately \$13.2 million of pension plan liabilities, deferred compensation liabilities of approximately \$13.5 million and the liability for uncertain tax positions of \$19.3 million at September 30, 2009. 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.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

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 Operations. 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. In the next year, we are obligated under our contract with the China Sports Lottery to purchase approximately 32,750 instant ticket validation machines for a total cost of approximately \$18.3 million. We are not party to any other material short-term or long-term obligations or commitments pursuant to these service contracts.

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. 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

Table of Contents

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, 2009, our available cash and borrowing capacity totaled \$414.5 million compared to \$330.8 million as of December 31, 2008. 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 \$72.4 million increase in our available cash from the December 31, 2008 level principally reflects the net cash provided by operating activities for the nine months ended September 30, 2009 of \$176.0 million along with \$76.0 million of net borrowings, offset by wagering and other capital expenditures and other investing activities totaling \$76.4 million and acquisition-related payments of \$89.5 million. The \$176.0 million of net cash provided by operating activities is derived from approximately \$156.8 million of net cash provided by operations and approximately \$19.2 million from changes in working capital. The working capital changes occurred principally from decreases in accounts receivable, inventories and prepaids, deposits and other current assets and increases in accrued interest and accrued income taxes, partially offset by decreases in accounts payable and other current liabilities. Capital expenditures were \$9.1 million in the nine months ended September 30, 2009 compared to \$10.9 million in the corresponding period in 2008. Wagering system expenditures totaled \$44.9 million in the nine months ended September 30, 2009 compared to \$119.3 million in the corresponding period in 2008, and consisted primarily of our lottery contracts in Pennsylvania and server-based gaming terminals related to Global Draw's contracts with its customers. Other intangible assets and software expenditures during the nine months ended September 30, 2009 consisted primarily of licensed properties, lottery contracts in Pennsylvania 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.

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, 2009, approximately 67% 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. Under the Hedge, SGI pays interest on a \$100 million notional amount of debt at a fixed rate of 3.49% and receives 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 our variable-rate debt.

Principal Amount by Expected Maturity Average Interest Rate**September 30, 2009****(Dollars in thousands)**

	Twelve Months Ended September 30						Total	FMV
	2010	2011	2012	2013	2014	Thereafter		
Debt at fixed interest rates	\$ 136,706	45,916	1,521	287,201	315	425,255	896,914	899,347
Weighted-average interest rates	2.0%	6.9%	2.7%	6.4%	1.4%	8.6%	6.8%	
Debt at variable interest rates	\$ 5,500	5,500	5,500	425,250			441,750	439,541
Weighted-average interest rates	4.0%	4.0%	4.0%	4.0%	0.0%	0.0%	4.0%	

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

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

periodic filings with the Securities and Exchange Commission.

There were no changes in our internal control over financial reporting during the quarter ended September 30, 2009 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 1A. Risk Factors

A restated description of the risk factors associated with our business is set forth below. This description includes any and all changes (whether or not material) to, and supersedes, the description of the risk factors associated with our business previously disclosed in Part I, Item 1A to our Annual Report on Form 10-K for the year ended December 31, 2008.

We operate in highly competitive industries and our success depends on our ability to effectively compete with numerous domestic and foreign businesses.

We face competition from a number of domestic and foreign businesses, some of which have substantially greater financial resources than we do, which could impact our ability to win new contracts and renew existing contracts. We continue to operate in a period of intense price-based competition, which could affect the number and the profitability of the contracts we win.

Contract awards by lottery authorities are sometimes challenged by unsuccessful bidders, which can result in costly and protracted legal proceedings that can result in delayed implementation or cancellation of the award. In addition, the domestic lottery market has matured such that the number of states conducting lotteries is unlikely to increase materially in the near-term.

We believe our principal competitors in the instant ticket lottery business are increasing their production capacity, which could increase pricing pressures in the instant ticket business and adversely affect our ability to win or renew instant ticket contracts or reduce the profitability of instant ticket contracts that we do win. Our domestic instant ticket business could also be adversely affected should additional foreign competitors in Canada or Mexico export their lottery products to the United States or should other foreign competitors establish printing facilities in the United States, Canada or Mexico to supply the United States.

We also face increased price competition in the online lottery business from our two principal competitors. Since late 2007, the lottery authorities in South Carolina, West Virginia, South Dakota, New Hampshire and Vermont awarded new online lottery contracts to our competitors. Our online lottery contracts with South Carolina, West Virginia and South Dakota terminated on November 15, 2008, June 27, 2009 and August 2, 2009, respectively, and our online lottery contracts with New Hampshire and Vermont each terminate on June 30, 2010. We also compete in the international instant ticket lottery business with low-price, low-quality printers in a regulated environment where laws are being reinterpreted so as to create competition from non-traditional lottery vendors and products.

Pricing pressures and potential privatization of some lotteries may also change the manner in which online and instant ticket contracts are awarded and the profitability of those contracts. Any future success of our lottery business will also depend, in part, on the success of the lottery industry in attracting and retaining players in the face of increased competition for these players' entertainment dollars, as well as our own success in developing innovative products and systems to achieve this goal. Our failure to achieve this goal could reduce revenues from our lottery operations. As a result of pressures on state and other government budgets, other forms of gaming may be legalized, which could

adversely impact our business.

We also operate in competitive markets in other parts of our business. Our pari-mutuel business faces competition from other operators, other gaming venues such as casinos and state-sponsored lotteries and other forms of legal and illegal gaming. The market for pari-mutuel wagering has seen declines over a period of years and the continuing popularity of horse and dog racing is important to the operating results of our pari-mutuel business. Our other gaming-related businesses face competition from other vendors and illegal operators, as well as changes in law and regulation that can affect our future profitability. In our prepaid phone card business, we are operating in a period of intense price-based competition, which may continue to negatively affect our revenues and operating margins. Moreover, the cellular telephone industry is undergoing technological changes such that other technologies, including electronic commerce, could impact our growth opportunities and our customer relationships in connection with our prepaid phone card business.

Recent changes to certain contracts and other aspects of our business, together with the current economic conditions and adverse foreign currency exchange rate fluctuations, have adversely affected our results of operations and may continue to do so.

Over the past several quarters, we have changed the pricing and pricing structure of certain of our lottery contracts and, in 2009, began selling instant lottery tickets in China through our joint venture rather than directly (and, therefore, the related revenues and expenses are no longer recognized in our revenue and expense line items). These changes, together with the current global economic conditions and adverse foreign currency exchange rate fluctuations, have had and may continue to have a negative effect on our results of operations. For example, our revenues in the first three quarters of 2009 decreased approximately \$160.0 million, or approximately 19%, compared to the same period in 2008. We expect these factors that negatively impacted our results in the first three quarters of 2009 to continue to do so into at least the fourth quarter of 2009.

In addition, we cannot predict the effect that the global economic conditions will have on us as it also impacts our customers, vendors and business partners. We believe that the lottery and wide area gaming businesses are less susceptible to reductions in consumer

Table of Contents

spending than the destination gaming business (e.g., resort/casino venues, which are typically less accessible than lottery and wide area gaming retail outlets) and other parts of the consumer sector. However, there can be no assurance that the continuation or worsening of the current global economic conditions will not negatively impact the lottery or wide area gaming businesses.

Our business is subject to evolving technology.

The markets for all of our products and services are affected by changing technology, new legislation and evolving industry standards. Our ability to anticipate or respond to such changes and to develop and introduce new and enhanced products and services on a timely basis will be a significant factor in our ability to expand, remain competitive, attract new customers and retain existing contracts.

We can give no assurance that we will achieve the necessary technological advances or have the financial resources needed to introduce new products or services on a timely basis or that we will otherwise have the ability to compete effectively in the markets we serve.

We are heavily dependent on our ability to renew our long-term contracts with our customers and we could lose substantial revenue and profits if we are unable to renew certain of our contracts.

Generally, our contracts are for initial terms of one to five years, with optional renewal periods. Upon the expiration of a contract, including any extensions thereof, new contracts may be awarded through a competitive bidding process. Since late 2007, the lottery authorities in South Carolina, West Virginia, South Dakota, New Hampshire and Vermont awarded new online lottery contracts to our competitors. Our revenues from our online contracts in these states represented approximately \$23.0 million, or approximately 2%, of our total 2008 revenues.

In addition, CLN's current concession from the Italian Monopoli di Stato under which CLN is the exclusive operator of the Italian Gratta e Vinci instant ticket lottery, and our contract to supply instant lottery tickets and other services to CLN, our largest customer, are scheduled to expire in June 2010.

On October 12, 2009, the members of CLN tendered for a new concession to operate the Gratta e Vinci instant ticket lottery upon the termination of CLN's current concession. Although a maximum of four concessions can be granted by the terms of the tender, we understand that our bidding group was the only group to submit a bid. The concession, anticipated to begin in June 2010, will have an initial term of nine years (subject to a performance evaluation during the fifth year) and may be extended by the Monopoli di Stato for an additional nine years. Pricing for the new concession is set at 11.9% of retail sales, inclusive of retailer commissions of 8.0%, compared to the current tiered pricing structure, which averaged 12.1% of retail sales in the second quarter of 2009 inclusive of retailer commissions of 8.0% and a VAT. The new rate is exclusive of VAT; however VAT will be charged on the operating expenses of the concessionaire.

A non-bidding third party filed a request with the TAR Lazio (Rome Administrative Court) seeking the suspension and annulment of the tender. We understand that the request claims that the tender is discriminatory and that it unlawfully limits competition. The request to suspend the tender was denied in hearings on October 14 and October 28, 2009. Another hearing has been scheduled for November 11, 2009 to address the request for annulment. We currently expect the results of the tender to be published in mid-November 2009. In the event that the request for

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

annulment is granted, we cannot predict what actions, if any, the Italian government or Monopoli di Stato will take, including potentially passing new legislation, amending the tender procedures, issuing new tender procedures or exercising its option to extend CLN's current concession.

In the event that our bidding group is the sole bidding group to be awarded a concession, our bidding group would be obligated to make upfront payments of \$520.0 million and \$280.0 million on or about November 30, 2009 and November 30, 2010, respectively. We would be responsible for our pro rata share of these payments (which would be \$104.0 million and \$56.0 million, respectively, assuming our ownership interest in the entity that holds the concession remains at 20%). In conjunction with the submission of its bid, our bidding group provided bank guarantees to support a \$40.0 million bid guarantee and a \$75 million performance guarantee. We guaranteed our pro rata share of these guarantees through the issuance of \$23.0 million of letters of credit under our revolving credit facilities.

There can be no assurance that our bidding group will be awarded a concession to continue to operate the instant ticket lottery following the termination of CLN's current concession or whether other operators will also be awarded a concession. In addition, there can be no assurance that we will continue to supply instant lottery tickets and/or other services under any future arrangements. In the event that our bidding group is awarded a concession, we anticipate that our bidding group will form and capitalize a new vehicle to hold the concession consistent with the tender requirements. We have entered into a memorandum of understanding with our current CLN partners with respect to the formation and governance of any new concession vehicle on terms substantially similar

Table of Contents

to the terms governing CLN. However, we cannot guarantee that we will be able to enter into definitive governing agreements, nor can we predict the final terms of any such definitive agreements (including terms relating to the structure of the vehicle and governance rights).

We are also required by certain of our lottery customers to provide surety or performance bonds in connection with our contracts. There can be no assurance that we will continue to be able to obtain surety or performance bonds on commercially reasonable terms or at all. Our inability to provide such bonds would materially and adversely affect our ability to renew existing, or obtain new, lottery contracts.

There can be no assurance that our current contracts will be extended or that we will be awarded new contracts as a result of competitive bidding processes in the future. The termination, expiration or failure to renew one or more of our contracts could cause us to lose substantial revenues and profits, which could have an adverse effect on our ability to win or renew other contracts or pursue acquisitions or other growth initiatives.

We may not have sufficient cash flows from operating activities, cash on hand and available borrowings under our credit facilities to finance required capital expenditures under new contracts, service our indebtedness and meet our other cash needs. These obligations require a significant amount of cash.

Our online lottery, wide area gaming and pari-mutuel contracts generally require significant up-front capital expenditures for terminal assembly, software customization and implementation, systems 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 or our ability to obtain additional financing at commercially reasonable terms. If we do not have adequate liquidity or are unable to obtain financing for these up-front costs on favorable terms or at all, we may not be able to bid on certain contracts, which could restrict our ability to grow and have a material adverse effect on our results of operations. Moreover, we may not realize the return on investment that we anticipate on new contracts due to a variety of factors, including lower than anticipated retail sales and unanticipated regulatory developments or litigation.

As of September 30, 2009, we had total indebtedness of approximately \$1,369.1 million (excluding \$125.0 million of additional 2009 Notes issued on November 5, 2009), or approximately 68.2% of our total capitalization, consisting primarily of senior secured term loan and revolving credit facilities under our credit agreement, senior subordinated notes and convertible senior subordinated debentures. Our ability to make payments on and to refinance our indebtedness will depend on our ability to generate cash in the future. This, to some extent, is subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control.

If we are unable to generate sufficient cash flow from operations in the future to meet our commitments, we will be required to adopt one or more alternatives, such as refinancing or restructuring our indebtedness, selling material assets or operations or seeking to raise additional debt or equity capital. There can be no assurance that any of these actions could be completed on a timely basis or on satisfactory terms or at all, or that these actions would enable us to continue to satisfy our capital requirements. Moreover, our existing or future debt agreements contain restrictive covenants that may prohibit us from adopting these alternatives. Our failure to comply with these covenants could result in an event of default which, if not cured or waived, could result in the acceleration of all of our debt.

In addition, as described below, a substantial portion of our long-term indebtedness may accelerate and become due in 2010 unless certain actions are taken to eliminate the right of the holders of our convertible debentures to require us to redeem or repurchase such convertible

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

debentures or unless our available liquidity exceeds the aggregate principal amount of such convertible debentures then outstanding plus \$50.0 million. During 2009, we have taken steps that we believe will allow us to address this potential acceleration event, including deferring a portion of the Global Draw earn-out payment by issuing the Global Draw promissory notes, completing the offerings of the 2009 Notes (and receiving net proceeds of approximately \$335.6 million) and repurchasing approximately \$174.6 million in aggregate principal amount of our convertible debentures (leaving approximately \$99.2 million in aggregate principal amount of our convertible debentures currently outstanding). Although we expect that we will be able to satisfy the conditions described above (including by having sufficient cash and liquidity), and thereby prevent the acceleration of such indebtedness, there can be no assurance that we will be able to do so.

Our credit facilities and the indentures governing our senior subordinated notes and our convertible debentures impose certain restrictions. Failure to comply with any of these restrictions could result in the acceleration of the maturity of our indebtedness. Were this to occur, we would not have sufficient cash to pay our accelerated indebtedness.

The operating and financial restrictions and covenants in our debt agreements, including our credit facilities and the indentures governing our senior subordinated notes and our convertible debentures, may adversely affect our ability to finance future operations or capital needs or to engage in new business activities. Our credit facilities and/or indentures will restrict our ability to, among other things:

- declare dividends or redeem or repurchase capital stock;
- prepay, redeem or purchase other debt;

Table of Contents

- incur liens;
- make loans, guarantees, acquisitions and investments;
- incur additional indebtedness;
- engage in sale and leaseback transactions;
- amend or otherwise alter debt and other material agreements;
- make capital expenditures;
- engage in mergers, acquisitions or asset sales;
- transact with affiliates; and
- alter the business we conduct.

In addition, our credit facilities require us to maintain certain financial ratios. As a result of these covenants, we will be limited in the manner in which we can conduct our business, and may be unable to engage in favorable business activities or finance future operations or capital needs. Accordingly, these restrictions may limit our ability to successfully operate our business. A failure to comply with the restrictions contained in the credit facilities or the indentures, or to maintain the financial ratios required by the credit facilities, could lead to an event of default which could result in an acceleration of the indebtedness. See Note 6 of the Notes to Consolidated Financial Statements for additional information regarding these financial ratios.

There can be no assurance that our future operating results will be sufficient to enable compliance with the covenants in our credit facilities, our indentures or other indebtedness or to remedy any such default. In addition, in the event of an acceleration, we may not have or be able to obtain sufficient funds to make any accelerated payments, including those under the notes.

The holders of our convertible debentures have the right to require us to repurchase some or all of their convertible debentures in June 2010, the Global Draw promissory notes will mature in May and June 2011, and our 2004 Notes will mature in December 2012. The maturity of borrowings under our credit facilities will be accelerated to March 2010, February 2011 or September 2012, respectively, if certain conditions related to our convertible debentures, Global Draw promissory notes 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 accrued and unpaid interest. If current market conditions continue and our common stock continues to trade at current levels, we believe it is likely that the holders of the debentures will exercise this repurchase right. In connection with that repurchase right, the terms of our credit facilities provide that the term loan facility and revolving credit facility 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 on or prior to March 1, 2010;
- 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 facilities, for purposes of and in an amount sufficient to discharge all payment obligations with respect to the convertible debentures) on or prior to March 1, 2010; or
- the sum of the aggregate unused and available revolving facility commitments plus unrestricted cash held by SGI and the guarantors on March 1, 2010 is not less than the sum of the principal amount of convertible debentures then outstanding plus \$50.0 million.

In addition, the promissory notes issued in connection with the deferred of a portion of the earn-out and contingent bonuses that were payable in connection with our 2006 acquisition of Global Draw mature in May and June 2011. In connection with the maturity of the Global Draw promissory notes, the terms of our credit facilities provide that the term loan facility and revolving credit facility will both mature on February 7, 2011 unless either:

- no such promissory notes remain outstanding on such date; or
- the sum of the aggregate unused and revolving facility commitments plus unrestricted cash held by SGI and the guarantors on such date is not less than the sum of the principal amount of such promissory notes then outstanding plus \$50.0 million.

Table of Contents

In addition, our 2004 Notes mature on December 15, 2012. In connection with the maturity of the 2004 Notes, the terms of our credit facilities provide that the term loan facility and revolving credit facility will both mature on September 15, 2012, unless either:

- 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) on or prior to September 15, 2012 ; or
- the sum of the aggregate unused and available revolving facility commitments plus unrestricted cash held by SGI and the guarantors on September 15, 2012 is not less than the sum of the principal amount of the 2004 Notes then outstanding plus \$50.0 million.

During 2009, we have taken steps that we believe will allow us to address the potential acceleration event with respect to our convertible debentures, including deferring a portion of the Global Draw earn-out payment by issuing the Global Draw promissory notes, completing the offerings of the 2009 Notes (and receiving net proceeds of approximately \$335.6 million) and repurchasing approximately \$174.6 million in aggregate principal amount of our convertible debentures (leaving approximately \$99.2 million in aggregate principal amount of our convertible debentures currently outstanding). We expect that we will be able to satisfy the conditions described above with respect to our convertible debentures in a timely manner (including by having sufficient cash and liquidity to satisfy the liquidity condition described above), and thereby prevent the indebtedness under our credit facilities from becoming accelerated at March 1, 2010. In addition, we expect to have enough cash and liquidity to retire all of our convertible debentures when holders have the right to require us to repurchase the convertible debentures in June 2010. However, there can be no assurance that we will be able to satisfy the foregoing conditions set forth above or to repay any accelerated indebtedness under our credit facilities or repurchase the convertible debentures in 2010 or such later date as such repurchase may be required, or to repay the Global Draw promissory notes in May and June 2011 or the 2004 Notes in 2012.

Our business depends on the protection of our intellectual property and proprietary information.

We believe that our success depends, in part, on protecting our intellectual property in the United States and in foreign countries. Our intellectual property includes certain patents and trademarks relating to our instant ticket games and wagering systems, as well as proprietary or confidential information that is not subject to patent or similar protection. Our intellectual property protects the integrity of our games, systems, products and services, which is a core value of the industries in which we operate. For example, our intellectual property is designed to ensure the security of the printing of our instant lottery tickets and prepaid phone cards and provide simple and secure validation of our lottery tickets. Competitors may independently develop similar or superior products, software, systems or business models. In cases where our intellectual property is not protected by an enforceable patent, such independent development may result in a significant diminution in the value of our intellectual property.

There can be no assurance that we will be able to protect our intellectual property. We enter into confidentiality or license agreements with our employees, vendors, consultants, and, to the extent legally permissible, our customers, and generally control access to, and the distribution of, our game designs, systems and other software documentation and other proprietary information, as well as the designs, systems and other software documentation and other information we license from others. Despite our efforts to protect these proprietary rights, unauthorized parties may try to copy our gaming products, business models or systems, use certain of our confidential information to develop competing products, or develop independently or otherwise obtain and use our gaming products or technology, any of which could have a material adverse effect on our business. Policing unauthorized use of our technology is difficult and expensive, particularly because of the global nature of our operations. The laws of other countries may not adequately protect our intellectual property.

There can be no assurance that our business activities, games, products and systems will not infringe upon the proprietary rights of others, or that other parties will not assert infringement claims against us. Any such claim and any resulting litigation, should it occur, could subject us to significant liability for damages and could result in invalidation of our proprietary rights, distract management, and/or require us to enter into costly and burdensome royalty and licensing agreements. Such royalty and licensing agreements, if required, may not be available on terms acceptable to us, or may not be available at all. In the future, we may also need to file lawsuits to defend the validity of our intellectual property rights and trade secrets, or to determine the validity and scope of the proprietary rights of others. Such litigation, whether successful or unsuccessful, could result in substantial costs and diversion of resources.

We rely on products and technologies that we license from third parties. There can be no assurance that these third-party licenses, or the support for such licenses, will continue to be available to us on commercially reasonable terms, if at all.

Our business competes on the basis of the security and integrity of our systems and products.

We believe that our success depends, in part, on providing secure products and systems to our vendors and customers. Attempts to penetrate security measures may come from various combinations of customers, retailers, vendors, employees and others. Our ability

Table of Contents

to monitor and ensure quality of our products is periodically reviewed and enhanced. Similarly, we constantly assess the adequacy of our security systems to protect against any material loss to any of our customers and the integrity of the product to end-users. There can be no assurance that our business will not be affected by a security breach or lapse, which could have a material adverse impact on our results of operations, business or prospects.

Our industry is subject to strict government regulations that may limit our existing operations and have a negative impact on our ability to grow.

In the United States and many other countries, lotteries, pari-mutuel and other forms of wagering must be expressly authorized by law. Once authorized, such activities are subject to extensive and evolving governmental regulation. Moreover, such gaming regulatory requirements vary from jurisdiction to jurisdiction. Therefore, we are subject to a wide range of complex gaming laws and regulations in the jurisdictions in which we are licensed. Most jurisdictions require that we be licensed, that our key personnel and certain of our security holders be found suitable or be licensed, and that our products be reviewed and approved before placement. If a license, approval or finding of suitability is required by a regulatory authority and we fail to seek or do not receive the necessary approval, license or finding of suitability, then we may be prohibited from distributing our products for use in the particular jurisdiction.

The regulatory environment in any particular jurisdiction may change in the future, and any such change could have a material adverse effect on our results of operations, business or prospects. Moreover, there can be no assurance that the operation of lotteries, pari-mutuel wagering facilities, video gaming industry machines, Internet gaming or other forms of lottery or wagering systems will be approved by additional jurisdictions or that those jurisdictions in which these activities are currently permitted will continue to permit such activities. Although we believe that we have developed procedures and policies designed to comply with the requirements of evolving laws, there can be no assurance that law enforcement or gaming regulatory authorities will not seek to restrict our business in their jurisdictions or even institute enforcement proceedings.

Moreover, in addition to the risk of an enforcement action, we also potentially risk an impact on our reputation in the event of any potential legal or regulatory investigation whether or not we are ultimately accused of or found to have committed any violation. We are required to obtain and maintain licenses from various state and local jurisdictions in order to operate certain aspects of our pari-mutuel business and we are subject to extensive background investigations and suitability standards in our lottery business. We also will become subject to regulation in any other jurisdiction where our customers operate in the future. There can be no assurance that we will be able to obtain new licenses or renew any of our existing licenses, and the loss, denial or non-renewal of any of our licenses could have a material adverse effect on our results of operations, business or prospects. Lottery authorities generally conduct background investigations of the winning vendor and its employees prior to and after the award of a lottery contract. Generally, regulatory authorities have broad discretion when granting, renewing or revoking these approvals and licenses. Lottery authorities with which we do business may require the removal of any of our employees deemed to be unsuitable and are generally empowered to disqualify us from receiving a lottery contract or operating a lottery system as a result of any such investigation. Our failure, or the failure of any of our key personnel, systems or machines, in obtaining or retaining a required license or approval in one jurisdiction could negatively impact our ability (or the ability of any of our key personnel, systems or gaming machines) to obtain or retain required licenses and approvals in other jurisdictions. The failure to obtain or retain a required license or approval in any jurisdiction would decrease the geographic areas where we may operate and generate revenues, decrease our share in the gaming marketplace and put us at a disadvantage compared with our competitors.

Some jurisdictions also require extensive personal and financial disclosure and background checks from persons and entities beneficially owning a specified percentage (typically 5% or more) of our equity securities. The failure of these beneficial owners to submit to such background checks and provide required disclosure could jeopardize the award of a lottery contract to us or provide grounds for termination of an existing lottery contract. Additional restrictions are often imposed by international jurisdictions in which we market our lottery systems on foreign

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

corporations, such as us, seeking to do business in such jurisdictions. In light of these regulations and the potential impact on our business, in 2007, our Board of Directors and our stockholders adopted an amendment to our restated certificate of incorporation that allows for the restriction of stock ownership by persons or entities who fail to comply with informational or other regulatory requirements under applicable gaming law, who are found unsuitable to hold our stock by gaming authorities or whose stock ownership adversely affect our ability to obtain, maintain, renew or qualify for a license, contract, franchise or other regulatory approval from a gaming authority. The licensing procedures and background investigations of the authorities that regulate our businesses and the amendment may inhibit potential investors from becoming significant stockholders or inhibit existing shareholders from retaining or increasing their ownership.

We have developed and implemented an internal compliance program in an effort to ensure that we comply with legal requirements imposed in connection with our wagering-related activities, as well as legal requirements generally applicable to all publicly traded corporations. The compliance program is run on a day-to-day basis by our Chief Compliance Officer with legal advice provided by our General Counsel and outside experts. The compliance program is overseen by the Compliance Committee of our Board of Directors, consisting of three outside directors. While we are firmly committed to full compliance with all applicable laws, there can be no assurance that such steps will prevent the violation of one or more laws or regulations, or that a violation by us or an employee will not result in the imposition of a monetary fine or suspension or revocation of one or more of our licenses.

Table of Contents

Gaming opponents persist in their efforts to curtail the expansion of legalized gaming, which, if successful, could limit our existing operations.

Legalized gaming is subject to opposition from gaming opponents. There can be no assurance that this opposition will not succeed in preventing the legalization of gaming in jurisdictions where these activities are presently prohibited or prohibiting or limiting the expansion of gaming where it is currently permitted, in either case to the detriment of our business, financial condition, results and prospects.

Our ability to complete future acquisitions of gaming and related businesses and integrate those businesses successfully could limit our future growth.

Part of our corporate strategy is to continue to pursue expansion and acquisition opportunities in gaming and related businesses. In connection with any such acquisitions, we could face significant challenges in managing and integrating the expanded or combined operations, including acquired assets, operations and personnel. There can be no assurance that acquisition opportunities will be available on acceptable terms or at all or that we will be able to obtain necessary financing or regulatory approvals to complete potential acquisitions. Our ability to succeed in implementing our strategy will depend to some degree upon the ability of our management to identify, complete and successfully integrate commercially viable acquisitions. Acquisition transactions may disrupt our ongoing business and distract management from other responsibilities.

Our revenues fluctuate due to seasonality and timing of equipment sales and, therefore, our periodic operating results are not guarantees of future performance.

Our pari-mutuel service revenues are subject to seasonality related to weather variations. The first and fourth quarters of the calendar year traditionally comprise the weakest period for our pari-mutuel wagering service revenue. 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. Additionally, the fourth quarter is typically the weakest quarter for Global Draw due to reduced wagering during the holiday season. This adversely affects the amounts wagered and our corresponding service revenues. In addition, our revenues in our Lottery Systems Group can be somewhat dependent on the size of jackpots of lottery games such as Powerball® and Mega Millions during the relevant period.

Lottery and wagering equipment sales and software license revenues usually reflect a limited number of large transactions, which may not recur on an annual basis. Consequently, revenues and operating margins can vary substantially from period to period as a result of the timing and magnitude of major equipment sales and software license revenue. As a general matter, lottery and wagering equipment sales generate lower operating margins than revenue from other aspects of our business. In addition, instant ticket and prepaid phone card sales may vary depending on the season and timing of contract awards, changes in customer budgets, ticket inventory levels, lottery retail sales and general economic conditions.

Our business could also be impacted by natural or man-made disasters such as Hurricane Katrina or the terrorist attack in New York on September 11, 2001. Although we have taken steps to have disaster recovery plans in place and maintain business interruption insurance, there can be no assurance that such an event would not have a significant impact on our business.

Our success depends in part on our ability to develop, enhance and/or introduce successful gaming concepts and game content.

In the Diversified Gaming Group, our Global Draw and Games Media businesses develop and source game content both internally and through third party suppliers. Games Media also seeks to secure third party brands for incorporation into its game content. We believe creative and appealing game content produces more revenue and net win for the gaming machine customers of these businesses and provides them with a competitive advantage, which in turn enhances the revenues of Global Draw and Games Media and their ability to attract new business or to retain existing business. In our lottery business, we believe that innovative gaming concepts and game content, such as multiplier games for our Lottery Systems Group and licensed brand game content for our Printed Products Group, can enhance the revenue of our lottery customers and distinguish us from our competitors. There can be no assurance that we will be able to sustain the success of our existing game content or effectively develop or obtain from third parties new and enhanced game content that will be widely accepted both by our customers and their end users.

We are dependent on our suppliers and contract manufacturers, and any failure of these parties to meet our performance and quality standards or requirements could cause us to incur additional costs or lose customers.

Our production of instant lottery tickets and prepaid phone cards, in particular, depends upon a continuous supply of raw materials, supplies, power and natural resources. Our operating results could be adversely affected by an interruption or cessation in the supply of these items or a serious quality assurance lapse.

We transmit certain wagering data utilizing satellite transponders, generally pursuant to long-term contracts. The technical failure of any of these satellites would require us to obtain other communication services, including other satellite access. In some cases, we employ backup systems to limit our exposure in the event of such a failure. There can be no assurance of access to such other satellites

Table of Contents

or, if available, the ability to obtain the use of such other satellites on favorable terms or in a timely manner. While satellite failures are infrequent, the operation of satellites is outside of our control.

Our contracts for the broadcast of signals are usually one-year contracts. Because of competitive and other factors, we cannot provide assurance that these broadcast contracts will be renewed. Elimination of our access to racing broadcast signals could have a material adverse affect on racing revenue as well as our ability to expand the business into new markets.

In addition, our Global Draw business has entered into a number of significant contracts whose performance depends upon our third party suppliers delivering equipment on schedule for Global Draw to meet its contract commitments. Failure of the suppliers to meet their delivery commitments could result in Global Draw being in breach of and subsequently losing those contracts, which loss could have a material adverse affect on our results of operations.

We may be liable for product defects or other claims relating to our products.

Our products could be defective, fail to perform as designed or otherwise cause harm to our customers, their equipment or their products. If any of our products are defective, we may be required to recall the products and/or repair or replace them, which could result in substantial expenses and affect our profitability. Any problems with the performance of our products could harm our reputation, which could result in a loss of sales to customers and/or potential customers. In addition, if our customers believe that they have suffered harm caused by our products, they could bring claims against us that could result in significant liability. Any claims brought against us by customers may result in diversion of management's time and attention, expenditure of large amounts of cash on legal fees, expenses, and payment of damages, decreased demand for our products and services, and injury to our reputation. Our insurance may not sufficiently cover a large judgment against us or a large settlement payment, and is subject to customary deductibles, limits and exclusions.

We have foreign operations, which subjects us to additional risks.

We are a global business and derive a substantial and growing portion of our revenue and profits from operations outside the United States. In fiscal year ended December 31, 2008, we derived approximately 50% of our total revenues from our operations outside of the United States. Our operations in foreign markets subject us to risks customarily associated with such operations, including:

- the complexity of foreign laws, regulations and markets;

- the impact of foreign labor laws and disputes;

- other economic, tax and regulatory policies of local governments; and

- the ability to attract and retain key personnel in foreign jurisdictions.

Additionally, foreign taxes paid by our foreign subsidiaries and joint venture interests on their earnings may not be recovered against our U.S. tax liability. At December 31, 2008, we had a deferred tax asset for our foreign tax credit (FTC) carry forward of approximately \$40.4 million. Although we will continue to explore tax planning strategies to use all of our FTC, at March 31, 2009, we established a valuation allowance of approximately \$33.8 million against the FTC deferred tax asset to reduce the asset to the net amount our management estimates is more likely than not to be realized. Further, we determined it is not more likely than not that the foreign taxes generated in 2009 will be realized in full against our U.S. tax liability during the FTC carry forward period. As a result, our 2009 annual effective income tax rate is expected to be greater than the federal statutory rate because of the valuation allowance established against the deferred tax asset for a portion of the FTC generated in 2009.

Our consolidated financial results are significantly affected by foreign currency exchange rate fluctuations. Foreign currency exchange rate exposures arise from current transactions and anticipated transactions denominated in currencies other than U.S. dollars and from the translation of foreign currency balance sheet accounts into U.S. dollar-denominated balance sheet accounts. We are exposed to currency exchange rate fluctuations because a significant portion of our revenues is denominated in currencies other than the U.S. dollar, particularly the British pound sterling and the Euro. Exchange rate fluctuations have in the past adversely affected our operating results and cash flows and may adversely affect our results of operations and cash flows and the value of our assets outside the United States in the future.

In addition, our ability to expand successfully in foreign markets involves other risks, including difficulties in integrating our foreign operations, risks associated with entering markets in which we may have little experience and the day-to-day management of a growing and increasingly geographically diverse company. Our investment in foreign markets often entails entering into joint ventures or other business relationships with locally based entities, which can involve additional risks arising from our lack of sole decision-making authority, our reliance on a partner's financial condition, inconsistency between our business interests or goals and those of our partners and disputes between us and our partners. In particular, our investment in CLN is a minority investment in an

Table of Contents

Italian consortium whose largest equity holder is Lottomatica S.p.A, an Italian entity, and we do not control decisions relating to the governance of the consortium, including with respect to the distribution of its cash earnings.

Through our joint ventures and wholly owned foreign enterprises, we have lottery-related investments and business operations in China, from which we expect to derive a growing portion of income. Our business and results of operations in China are subject to a number of risks, including risks relating to our ability to finance our operations in China, the complex regulatory environment in China, the political climate in China, the Chinese economy and our joint venture and other business partners in China. Two of our joint ventures are with locally based state-owned enterprises, which can potentially heighten the joint venture-related risks described above relating to inconsistency of business interests and disputes.

We believe that our operations in China are in compliance with all applicable legal and regulatory requirements. However, there can be no assurance that legal and regulatory requirements in China will not change or that China's central or local governments will not impose new, stricter regulations or interpretations of existing regulations that would impose additional costs on our operations in China or even restrict or prohibit such operations. For example, comprehensive legislation regulating competition took effect in August 1, 2008. This new law, among other things, prohibits certain types of agreements (unless they fall within specified exemptions) and certain behavior classified as abuse of dominant market position or intellectual property rights. Additionally, new lottery regulations providing for enhanced supervision of the lottery industry in China became effective on July 1, 2009. Although we do not believe these new laws will have a material adverse effect on our results of operations, we cannot predict with certainty what impact the new law (or implementing rules or enforcement policy) will have on our business in China (including whether or to what extent, the law applies to state-owned business or joint ventures in which they participate).

We may not realize the operating efficiencies, market position or financial results that we anticipate from our investments in foreign markets and our failure to effectively manage the above risks associated with our operations in foreign markets could have a material adverse effect on our results of operations, business or prospects.

We recognize significant earnings from our investment in CLN but we do not control distributions of its cash. CLN's current concession to operate the Gratta e Vinci instant ticket lottery and our contract with CLN to supply CLN instant lottery tickets and other services are scheduled to expire in 2010.

We are a 20% equity owner in CLN, the income from which we account for under the equity method of accounting. Our investment in CLN resulted in a significant portion of our income in 2008. For the year ended December 31, 2008, we recorded equity in net income of approximately \$51.7 million attributable to our interest in CLN. For the nine months ended September 30, 2009, we recorded equity in net income of approximately \$37.8 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 CLN. If CLN does not distribute earnings to its equity holders, we may record significant income attributable to our interest in CLN but will not receive commensurate cash flow. Any inability to access cash earned by the consortium could adversely affect our ability to pay our obligations under the notes.

In addition, CLN's current concession as the exclusive operator of the Gratta e Vinci instant ticket lottery and our contract to supply instant lottery tickets and other services to CLN are scheduled to expire in June 2010.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

On October 12, 2009, the members of CLN tendered for a new concession to operate the Gratta e Vinci instant ticket lottery upon the termination of CLN's current concession. Although a maximum of four concessions can be granted by the terms of the tender, we understand that our bidding group was the only group to submit a bid. The concession, anticipated to begin in June 2010, will have an initial term of nine years (subject to a performance evaluation during the fifth year) and may be extended by the Monopoli di Stato for an additional nine years. Pricing for the new concession is set at 11.9% of retail sales, inclusive of retailer commissions of 8.0%, compared to the current tiered pricing structure, which averaged 12.1% of retail sales in the second quarter of 2009 inclusive of retailer commissions of 8.0% and a VAT. The new rate is exclusive of VAT; however VAT will be charged on the operating expenses of the concessionaire.

A non-bidding third party filed a request with the TAR Lazio (Rome Administrative Court) seeking the suspension and annulment of the tender. We understand that the request claims that the tender is discriminatory and that it unlawfully limits competition. The request to suspend the tender was denied in hearings on October 14 and October 28, 2009. Another hearing has been scheduled for November 11, 2009 to address the request for annulment. We currently expect the results of the tender to be published in mid-November 2009. In the event that the request for annulment is granted, we cannot predict what actions, if any, the Italian government or Monopoli di Stato will take, including potentially passing new legislation, amending the tender procedures, issuing new tender procedures or exercising its option to extend CLN's current concession.

Table of Contents

In the event that our bidding group is the sole bidding group to be awarded a concession, our bidding group would be obligated to make upfront payments of \$520.0 million and \$280.0 million on or about November 30, 2009 and November 30, 2010, respectively. We would be responsible for our pro rata share of these payments (which would be \$104.0 million and \$56.0 million, respectively, assuming our ownership interest in the entity that holds the concession remains at 20%). In conjunction with the submission of its bid, our bidding group provided bank guarantees to support a \$40.0 million bid guarantee and a \$75 million performance guarantee. We guaranteed our pro rata share of these guarantees through the issuance of \$23.0 million of letters of credit under our revolving credit facilities.

There can be no assurance that our bidding group will be awarded a concession to continue to operate the instant ticket lottery following the termination of CLN's current concession or whether other operators will also be awarded a concession. In addition, there can be no assurance that we will continue to supply instant lottery tickets and/or other services under any future arrangements. In the event that our bidding group is awarded a concession, we anticipate that our bidding group will form and capitalize a new vehicle to hold the concession consistent with the tender requirements. We have entered into a memorandum of understanding with our current CLN partners with respect to the formation and governance of any new concession vehicle on terms substantially similar to the terms governing CLN. However, we cannot guarantee that we will be able to enter into definitive governing agreements, nor can we predict the final terms of any such definitive agreements (including terms relating to the structure of the vehicle and governance rights).

Certain holders of our common stock exert significant influence over the Company and may make decisions that conflict with the interests of our creditors.

In August 2004, MacAndrews & Forbes Holdings Inc. was issued approximately 25% of our outstanding common stock in connection with its conversion of our then outstanding Series A Convertible Preferred Stock. According to a Form 4 filed with the SEC on January 6, 2009, this holder beneficially owns 25,985,737 shares of our common stock, or approximately 28% of our currently outstanding common stock. Such holder is entitled to appoint up to four members of our Board of Directors under a stockholders' agreement with us, as supplemented, which we originally entered into with holders of the Series A Convertible Preferred Stock, and certain actions of the Company require the approval of such holder. As a result, this holder has the ability to exert significant influence over our business and may make decisions with which other stockholders may disagree, including, among other things, delaying, discouraging or preventing a change of control of the Company or a potential merger, consolidation, tender offer, takeover or other business combination.

If certain of our key personnel leave us, our business will be significantly adversely affected.

We depend on the continued performance of our senior management team. Additionally, we depend on certain of our directors, including our Chairman A. Lorne Weil for overall strategic and organizational guidance and advice on business development projects and mergers and acquisitions. Mr. Weil and our senior management team have extensive experience in the lottery and pari-mutuel businesses. If we lose the services of Mr. Weil or any of our senior officers and cannot find suitable replacements for such persons in a timely manner, it could have a material adverse effect on our business.

We could incur costs in the event of violations of or liabilities under environmental laws.

Edgar Filing: SCIENTIFIC GAMES CORP - Form 10-Q

Our operations and real properties are subject to U.S. and foreign environmental laws and regulations, including those relating to air emissions, the management and disposal of hazardous substances and wastes, and the cleanup of contaminated sites. We could incur costs, including cleanup costs, fines or penalties, and third-party claims as a result of violations of or liabilities under environmental laws. Some of our operations require environmental permits and controls to prevent or reduce environmental pollution, and these permits are subject to review, renewal and modification by issuing authorities. We believe that our operations are currently in substantial compliance with all environmental laws, regulations and permits and have not historically incurred material costs for noncompliance with, or liabilities under, these requirements.

Failure to perform under our lottery contracts may result in litigation, substantial monetary liquidated damages and contract termination.

Our business subjects us to contract penalties and risks of litigation, including due to potential allegations that we have not fully performed under our contracts or that goods or services we supply are defective in some respect. Litigation is pending in Colombia arising out of the termination of certain Colombian lottery contracts in 1993. An agency of the Colombian government has asserted claims against certain parties, including SGI, which owned a minority interest in Wintech de Colombia S.A., or Wintech (now liquidated), the former operator of the Colombian national lottery. The claims are for, among other things, contract penalties, interest and the costs of a bond issued by a Colombian surety. For additional information regarding this litigation see Item 3 Legal Proceedings included in our Annual Report on Form 10-K. Recently, a Colombian court ruled against Wintech's appeal (to which we are not party) of an action by the Colombian governmental agency that arises out of the same claims asserted by the Colombian governmental agency against SGI. Although we believe that any potential losses arising from this litigation will not result in a material

Table of Contents

adverse effect on our consolidated financial position or results of operations, we cannot predict the final outcome, and there can be no assurance that this litigation will not be finally resolved adversely to us or result in material liability.

Table of Contents

In addition, our lottery contracts typically permit a lottery authority to terminate the contract at any time for material failure to perform, other specified reasons and, in many cases, for no reason at all. Lottery contracts to which we are a party also frequently contain exacting implementation schedules and performance requirements and the failure to meet these schedules and requirements may result in substantial monetary liquidated damages, as well as possible contract termination. We are also required by certain of our lottery customers to provide surety or performance bonds. We have paid or incurred liquidated damages under our lottery contracts and material amounts of liquidated damages could be imposed on us in the future, which could, if imposed, have a material adverse effect on our results of operations, business or prospects.

Labor disputes may have an adverse effect on our operations.

Although we have increasingly automated our pari-mutuel field operations and created two hub centers, we have union employees in our pari-mutuel field operations in the United States and Canada. We collectively bargain with the labor unions that represent these employees. The collective bargaining agreement representing the majority of our union employees in our pari-mutuel field operations in the United States and the collective bargaining agreement relating to our Canadian racing operations expired on October 20, 2009. We have reached tentative agreement, subject to member ratification, on a two-year extension to our agreement with the union representing our pari-mutuel field employees in the United States. Negotiations are currently scheduled for the fourth quarter of 2009 with respect to our agreement relating to Canadian racing operations (which agreement will continue in effect pending such negotiations). Although we believe we will be able to finalize extensions to these union agreements, there can be no assurance that we will be able to do so. In addition, notwithstanding these agreements and negotiations, if we were to experience a union strike or work stoppage, it would be difficult to find sufficient replacement employees with the proper skills. Certain of our other employees are represented by unions, including certain employees at our printing facilities in Australia, Canada, Chile and United Kingdom and at one of our Connecticut OTB locations. There can be no assurance that we will not encounter any conflicts or strikes with any labor union that represents our employees, which could have an adverse effect on our business or results of operations, could cause us to lose customers or could cause our customers' operations to be affected and might have permanent effects on our business.

The price of our common stock has been volatile and may continue to be volatile.

Our stock price may fluctuate in response to a number of events and factors, such as, variations in operating results, actions by various regulatory agencies, litigation, market perceptions of our financial reporting, financial estimates and recommendation by securities analysts, rating agency reports, performance of other companies that investors or security analysts deem comparable to us, news reports relating to our business, our markets or general market conditions. During the 52-week period ending on September 30, 2009, our stock price fluctuated between a high of \$19.33 and a low of \$10.58. This significant stock price fluctuation may make it more difficult for our stockholders to resell their common stock when they want and at prices they find attractive.

Table of Contents**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)
7/1/2009 - 7/31/2009	15,592	\$ 16.05		\$ 161.5 million
8/1/2009 - 8/31/2009	4,490	\$ 17.96		\$ 161.5 million
9/1/2009 - 9/30/2009		\$		\$ 161.5 million
Total	20,082	\$ 16.48		\$ 161.5 million

(1) 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, 2009.

(2) The \$200 million stock repurchase program, which expires on December 31, 2009, was originally publicly announced on November 2, 2006, extended on December 13, 2007 and extended again on December 11, 2008.

On August 17, 2009 our board of directors approved an increase to the amount authorized under our previously announced program for the Convertible Debentures from \$158.3 million to \$183.3 million in aggregate principal amount. During the three and nine months ended September 30, 2009, the Company repurchased approximately \$43.2 million and \$174.6 million, respectively, in aggregate principal amount of the Convertible Debentures for approximately \$42.4 million and \$166.4 million in cash, respectively. There was approximately \$99.2 million in aggregate principal amount of Convertible Debentures outstanding as of September 30, 2009. Purchases are funded by cash flows from operations, borrowings, or a combination thereof. The manner, timing and amount of purchases is determined by our management based on its evaluation of market conditions, price of the Convertible Debentures and other factors. The program may be suspended or discontinued at any time.

Table of Contents

Item 6. Exhibits

**Exhibit
Number**

- 10.1 Second Amendment, dated as of September 30, 2009, among SGI, as borrower, the Company, as guarantor, the several lenders from time to time party thereto and JPMorgan Chase Bank, N.A., as administrative agent, which amended the Credit Agreement, dated as of June 9, 2008 and amended as of March 27, 2009, among such parties (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 2, 2009).
- 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/ Jeffrey S. Lipkin
Name: Jeffrey S. Lipkin
Title: Vice President and Chief Financial Officer
(principal financial officer)

Dated: November 9, 2009

Table of Contents

INDEX TO EXHIBITS

**Exhibit
Number**

- 10.1 Second Amendment, dated as of September 30, 2009, among SGI, as borrower, the Company, as guarantor, the several lenders from time to time party thereto and JPMorgan Chase Bank, N.A., as administrative agent, which amended the Credit Agreement, dated as of June 9, 2008 and amended as of March 27, 2009, among such parties (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 2, 2009).
- 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.