

SCIENTIFIC GAMES CORP
Form 10-Q
November 02, 2011
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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, 2011

OR

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

For the transition period from to

Commission file number: 0-13063

SCIENTIFIC GAMES CORPORATION

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

81-0422894

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

750 Lexington Avenue, New York, New York 10022

(Address of principal executive offices)

(Zip Code)

(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

Smaller reporting company

(Do not check if a smaller reporting company)

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

The registrant has the following number of shares outstanding of each of the registrant's classes of common stock as of October 28, 2011:

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Class A Common Stock: **92,137,470**

Class B Common Stock: **None**

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

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AND OTHER INFORMATION

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011

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Forward-Looking Statements

Throughout this Quarterly Report on Form 10-Q we make forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements describe future expectations, plans, results or strategies and can often be identified by the use of terminology such as may, will, estimate, intend, continue, believe, expect, anticipate, could, potential, opportunity, or other similar terminology. The forward-looking statements contained in this Quarterly Report on Form 10-Q are generally located in the material set forth under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations but may be found in other locations as well. These statements are based upon management's current expectations, assumptions and estimates and are not guarantees of future results or performance. Actual results may differ materially from those projected in these statements due to a variety of risks and uncertainties and other factors, including, among other things: competition; material adverse changes in economic and industry conditions; technological change; retention and renewal of existing contracts and entry into new or revised contracts; availability and adequacy of cash flows 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; inability to benefit from, and risks associated with joint ventures and strategic investments and relationships; failure of the Company's Northstar joint venture to meet the net income targets or otherwise realize the anticipated benefits under its private management agreement with the Illinois Lottery; seasonality; inability to identify and capitalize on trends and changes in the lottery and gaming industries; inability to enhance and develop successful gaming concepts; dependence on suppliers and manufacturers; liability for product defects; fluctuations in foreign currency exchange rates and other factors associated with foreign operations; influence of certain stockholders; 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 included from time to time in our filings with the Securities and Exchange Commission (SEC), including under the heading Risk Factors in our most recent Annual Report on Form 10-K and in this Quarterly Report on Form 10-Q. Forward-looking statements speak only as of the date they are made and, except for our ongoing obligations under the U.S. federal securities laws, we undertake no obligation to publicly update any forward-looking statements whether as a result of new information, future events or otherwise.

You should also note that this Quarterly Report on Form 10-Q may contain various references to industry market data and certain industry forecasts. Industry market data and industry forecasts are obtained from publicly available information and industry publications. Industry publications generally state that the information contained therein has been obtained from sources believed to be reliable, but that the accuracy and completeness of that information is not guaranteed. Similarly, industry forecasts, while we believe them to be accurate, are not independently verified by us and we do not make any representation as to the accuracy of that information. In general, there is less publicly available information concerning the international lottery industry than the lottery industry in the U.S.

Table of Contents**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

As of September 30, 2011 and December 31, 2010

(Unaudited, in thousands, except per share amounts)

| ASSETS | | |
|---|------------------|------------------|
| Current assets: | | |
| Accounts receivable, net of allowance for doubtful accounts of \$6,469 and \$2,175 as of September 30, 2011 and December 31, 2010, respectively | 187,236 | 178,179 |
| Deferred income taxes, current portion | 2,339 | 2,448 |
| Total current assets | 408,285 | 413,665 |
| Less: accumulated depreciation | (342,631) | (325,786) |
| Goodwill, net | 766,288 | 763,915 |
| Other assets and investments | 494,677 | 452,764 |
| Current liabilities: | | |
| Accounts payable | 64,640 | 50,642 |
| Total current liabilities | 234,272 | 195,998 |
| Other long-term liabilities | 57,517 | 53,765 |
| Total liabilities | 1,735,564 | 1,698,880 |
| Stockholders' equity: | | |
| Additional paid-in capital | 689,861 | 674,691 |

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| | | |
|---|----------|----------|
| Treasury stock, at cost, 5,749 shares held as of September 30, 2011 and December 31, 2010 | (74,460) | (74,460) |
| Total stockholders' equity | 460,777 | 452,658 |

See accompanying notes to consolidated financial statements

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

Three Months Ended September 30, 2011 and 2010

(Unaudited, in thousands, except per share amounts)

| | Three Months Ended September 30, | |
|---|----------------------------------|------------|
| | 2011 | 2010 |
| Revenue: | | |
| Instant tickets | \$ 126,693 | \$ 115,968 |
| Services | 81,429 | 92,813 |
| Sales | 14,617 | 12,280 |
| Total revenue | 222,739 | 221,061 |
| Operating expenses: | | |
| Cost of instant tickets (1) | 71,785 | 67,138 |
| Cost of services (1) | 42,562 | 57,723 |
| Cost of sales (1) | 10,332 | 7,977 |
| Selling, general and administrative expenses | 47,660 | 36,435 |
| Write-down of assets held for sale | | 2,155 |
| Employee termination and restructuring costs | 1,030 | 602 |
| Depreciation and amortization | 27,994 | 27,284 |
| Operating income | 21,376 | 21,747 |
| Other (income) expense: | | |
| Interest expense | 26,297 | 24,617 |
| Earnings from equity investments | (8,895) | (13,031) |
| Loss on early extinguishment of debt | 4,185 | 2,236 |
| Other (income) expense, net | 1,711 | (3,011) |
| | 23,298 | 10,811 |
| Net (loss) income before income taxes | (1,922) | 10,936 |
| Income tax expense | 2,202 | 2,232 |
| Net (loss) income | \$ (4,124) | \$ 8,704 |
| Basic and diluted net (loss) income per share: | | |
| Basic net (loss) income per share | \$ (0.04) | \$ 0.09 |
| Diluted net (loss) income per share | \$ (0.04) | \$ 0.09 |
| Weighted-average number of shares used in per share calculations: | | |
| Basic shares | 92,125 | 91,844 |
| Diluted shares | 92,125 | 92,240 |

(1) Exclusive of depreciation and amortization.

See accompanying notes to consolidated financial statements

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

Nine Months Ended September 30, 2011 and 2010

(Unaudited, in thousands, except per share amounts)

| | Nine Months Ended September 30, | |
|---|---------------------------------|------------|
| | 2011 | 2010 |
| Revenue: | | |
| Instant tickets | \$ 370,972 | \$ 343,506 |
| Services | 237,272 | 287,527 |
| Sales | 31,399 | 39,400 |
| Total revenue | 639,643 | 670,433 |
| Operating expenses: | | |
| Cost of instant tickets (1) | 211,151 | 199,282 |
| Cost of services (1) | 122,944 | 167,336 |
| Cost of sales (1) | 21,383 | 27,843 |
| Selling, general and administrative expenses | 130,640 | 115,543 |
| Write-down of assets held for sale | | 8,029 |
| Employee termination and restructuring costs | 1,030 | 602 |
| Depreciation and amortization | 87,902 | 82,017 |
| Operating income | 64,593 | 69,781 |
| Other (income) expense: | | |
| Interest expense | 79,161 | 74,176 |
| Earnings from equity investments | (27,469) | (42,474) |
| Loss on early extinguishment of debt | 4,185 | 2,236 |
| Other (income) expense, net | (159) | 9,555 |
| | 55,718 | 43,493 |
| Net income before income taxes | 8,875 | 26,288 |
| Income tax expense | 12,912 | 17,040 |
| Net (loss) income | \$ (4,037) | \$ 9,248 |
| Basic and diluted net (loss) income per share: | | |
| Basic net (loss) income per share | \$ (0.04) | \$ 0.10 |
| Diluted net (loss) income per share | \$ (0.04) | \$ 0.10 |
| Weighted-average number of shares used in per share calculations: | | |
| Basic shares | 92,027 | 93,122 |
| Diluted shares | 92,027 | 93,648 |

(1) Exclusive of depreciation and amortization.

See accompanying notes to consolidated financial statements

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Nine Months Ended September 30, 2011 and 2010

(Unaudited, in thousands, except per share amounts)

| | Nine Months Ended September 30, | |
|---|---------------------------------|------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (4,037) | \$ 9,248 |
| Adjustments to reconcile net (loss) income to cash provided by operating activities: | | |
| Depreciation and amortization | 87,902 | 82,017 |
| Change in deferred income taxes | 2,326 | 11,541 |
| Stock-based compensation | 15,293 | 17,383 |
| Non-cash interest expense | 6,122 | 5,276 |
| Undistributed earnings from equity investments | 2,611 | (8,062) |
| Write-down of assets held for sale | | 8,029 |
| Loss on extinguishment of debt | 4,185 | 2,236 |
| Changes in current assets and liabilities, net of effects of acquisitions | | |
| Accounts receivable | 9,380 | 7,012 |
| Inventories | (827) | (2,375) |
| Accounts payable | (2,125) | (8,970) |
| Accrued liabilities | 14,671 | (3,463) |
| Other current assets and liabilities | 16,163 | 22,886 |
| Other | 963 | 483 |
| Net cash provided by operating activities | 152,627 | 143,241 |
| Cash flows from investing activities: | | |
| Capital expenditures | (5,863) | (6,873) |
| Lottery and gaming systems expenditures | (33,972) | (45,257) |
| Other intangible assets and software expenditures | (28,536) | (26,335) |
| Change in other assets and liabilities, net | (11,356) | (571) |
| Net equity investments | (37,878) | (127,314) |
| Business acquisitions, net of cash acquired | (50,177) | (12,493) |
| Net cash used in investing activities | (167,782) | (218,843) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of long-term debt | | 355,541 |
| Payments on long-term debt | (6,232) | (242,758) |
| Payments of financing fees | (9,186) | (12,969) |
| Purchases of treasury stock | | (26,334) |
| Net proceeds from issuance of common stock | (1,426) | (2,067) |
| Net cash (used in) provided by financing activities | (16,844) | 71,413 |
| Effect of exchange rate changes on cash and cash equivalents | (5,403) | (8,965) |
| Decrease in cash and cash equivalents | (37,402) | (13,154) |
| Cash and cash equivalents, beginning of period | 124,281 | 260,131 |
| Change in cash and cash equivalents of held for sale operations at September 30, 2010 | | 2,593 |
| Cash and cash equivalents, end of period | \$ 86,879 | \$ 249,570 |

See accompanying notes to consolidated financial statements

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SCIENTIFIC GAMES CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Nine Months Ended September 30, 2011 and 2010

(Unaudited, in thousands, except per share amounts)

Non-cash investing and financing activities

For the nine months ended September 30, 2011 and 2010

Our total investment in International Terminal Leasing (ITL), which is described in Note 3 of the Notes to Consolidated Financial Statements, was \$35,961 as of September 30, 2011 which includes a non-cash investment of \$4,859 during the nine months ended September 30, 2011. There were no significant non-cash investing and financing activities for the nine months ended September 30, 2010.

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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, 2011, the Consolidated Statements of Operations for the three and nine months ended September 30, 2011 and 2010, and the Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010, have been prepared by Scientific Games Corporation and are unaudited. When used in these notes, the terms we, us, our and the 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, 2011, the results of our operations for the three and nine months ended September 30, 2011 and 2010 and our cash flows for the nine months ended September 30, 2011 and 2010 have been made. Such adjustments are of a normal, recurring nature.

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 2010 Annual Report on Form 10-K. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results of operations for the full year.

Significant Accounting Policies

We describe our significant accounting policies in Note 1 of the Notes to Consolidated Financial Statements in our 2010 Annual Report on Form 10-K. There have been no changes to our significant accounting policies during the period ended September 30, 2011 except as discussed below.

In September 2009, the Financial Accounting Standards Board (FASB) amended the Accounting Standards Codification (ASC) as summarized in Accounting Standards Update (ASU) 2009-14, *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements*, and ASU 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements*. As summarized in ASU 2009-14, ASC Topic 985 has been amended to remove from the scope of industry-specific revenue accounting guidance for software and software related

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transactions, tangible products containing software components and non-software components that function together to deliver the product's essential functionality. As summarized in ASU 2009-13, ASC Topic 605 has been amended: (1) to provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and the consideration allocated; (2) to require an entity to allocate revenue in an arrangement using estimated selling prices of deliverables if a vendor does not have vendor-specific objective evidence or third-party evidence of the selling price; and (3) to eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method. The accounting changes summarized in ASU 2009-14 and ASU 2009-13 are both effective for fiscal years beginning on or after June 15, 2010, with early adoption permitted. Adoption may either be on a prospective basis or by retrospective application.

We adopted these amendments to the ASC on January 1, 2011 on a prospective basis as applicable to our revenue generated from licensing branded properties that are coupled with a service component, where we also purchase and distribute prizes on behalf of lottery authorities. The impact of these accounting changes was not material to our consolidated financial statements for the three and nine months ended September 30, 2011.

Table of Contents*Basic and Diluted Net Income (Loss) Per Share*

The following represents a reconciliation of the numerator and denominator used in computing basic and diluted net (loss) income per share available to common stockholders for the three and nine months ended September 30, 2011 and 2010:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| Income (numerator) | | | | |
| Net (loss) income | \$ (4,124) | \$ 8,704 | \$ (4,037) | \$ 9,248 |
| Shares (denominator) | | | | |
| Weighted-average basic common shares outstanding | 92,125 | 91,844 | 92,027 | 93,122 |
| Effect of dilutive securities-stock rights | | 396 | | 526 |
| Weighted-average diluted common shares outstanding | 92,125 | 92,240 | 92,027 | 93,648 |
| Basic and diluted per share amounts | | | | |
| Basic net (loss) income per share | \$ (0.04) | \$ 0.09 | \$ (0.04) | \$ 0.10 |
| Diluted net (loss) income per share | \$ (0.04) | \$ 0.09 | \$ (0.04) | \$ 0.10 |

There were no dilutive stock rights for the three and nine months ended September 30, 2011 due to the net loss reported for the periods. The weighted-average diluted common shares outstanding for the three and nine months ended September 30, 2010 excludes the effect of approximately 6,917 and 6,496 weighted-average stock rights outstanding, respectively, because their effect would be anti-dilutive.

(2) Reportable Segment Information

We operate in three reportable segments: Printed Products Group, Lottery Systems Group, and Diversified Gaming Group. During the first quarter of 2011 we reviewed the allocation of overhead expenses to our reportable segments as a result of the realignment of our management structure. Based on this review, we determined to no longer allocate certain overhead expenses to our reportable segments. This change, which was effective January 1, 2011, had no impact on the Company's consolidated balance sheets or its statements of operations, cash flows or changes in stockholders' equity for any periods. Prior period reportable segment information has been adjusted to reflect the change in reportable segment reporting.

The following tables set forth revenue, cost of revenue, depreciation, amortization, selling, general and administrative expenses, write-down of assets held for sale, employee termination and restructuring costs, and operating income for the three and nine months ended September 30, 2011 and 2010, by reportable segments. Corporate expenses, including interest expense, other (income) expense and corporate depreciation and amortization, are not allocated to the reportable segments and are presented as unallocated corporate costs.

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| | Three Months Ended September 30, 2011 | | | | Totals |
|--|---------------------------------------|--------------------------|-----------------------------|----|---------|
| | Printed Products Group | Lottery Systems Group | Diversified Gaming Group | | |
| Revenue: | | | | | |
| Instant tickets | \$ 126,693 | \$ | \$ | \$ | 126,693 |
| Services | | 49,944 | 31,485 | | 81,429 |
| Sales | 2,953 | 9,640 | 2,024 | | 14,617 |
| Total revenue | \$ 129,646 | \$ 59,584 | \$ 33,509 | \$ | 222,739 |
| Cost of instant tickets (1) | \$ 71,785 | \$ | \$ | \$ | 71,785 |
| Cost of services (1) | | 26,899 | 15,663 | | 42,562 |
| Cost of sales (1) | 1,906 | 6,813 | 1,613 | | 10,332 |
| Selling, general and administrative expenses | 13,029 | 6,626 | 4,238 | | 23,893 |
| Employee termination and restructuring costs | | | 1,030 | | 1,030 |
| Depreciation and amortization | 8,177 | 11,939 | 7,744 | | 27,860 |
| Segment operating income | \$ 34,749 | \$ 7,307 | \$ 3,221 | \$ | 45,277 |
| Unallocated corporate costs | | | | | 23,901 |
| Consolidated operating income | | | | \$ | 21,376 |

(1) Exclusive of depreciation and amortization.

| | Three Months Ended September 30, 2010 | | |
|--|---------------------------------------|--------------------------|-----------------------------|
| | Printed Products Group | Lottery Systems Group | Diversified Gaming Group |