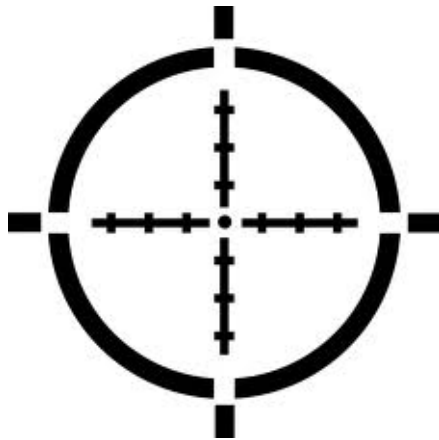


Scientific Games Corporation

Client Report

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Executive Summary

Headquartered in New York City, Scientific Games Corporation (SGMS) employs 3500 people across the world and is a leader in the global lottery and gaming industries. In its Lottery business segment, SGMS designs instant lottery games, in which a winning ticket is identified by removing a scratch-off coating from the purchased ticket, and draw lottery games, in which a series of randomly selected numbers determine the winner. It also designs monitoring and security systems for lottery administrators to ensure the integrity of games. In its Gaming Business, Scientific Games produces and sells slot machines, video game gambling terminals, and central monitoring systems to a variety of customers such as casinos, racetrack operators, truck stops, night clubs, and arcade halls.

Founded in 1972, Scientific Games Corporation originally focused exclusively on the U.S. lottery business, providing lottery-based products and services to state governments on a contractual, revenue-sharing basis. In the 1990s, SGMS expanded its business to begin the production of slot machines and other interactive gambling terminals. It will become an even larger player in this market following a \$1.5 billion merger with slot-machine manufacturer WMS Industries completed in October 2013. Since 2000, SGMS has pursued strategies of overseas expansion through the acquisition of smaller companies, usually valued between \$30 and \$50 million, with existing operations in targeted markets. As a result, SGMS is now a worldwide player in both industries, with operations in fifty countries across five different continents. Because of its rapid worldwide expansion into highly regulated and competitive industries, Scientific Games must develop strong client relationships, meet varying compliance standards across different jurisdictions, and work to develop superior product lines to differentiate itself from competition. In this report, DangerZone Consulting outlines two major strategic issues for Scientific Games Corporation.

The first is that the company must work to increase demand end-consumer demand in both the lottery and gaming businesses. This will require more improvement of sales and marketing campaigns in the lottery business and the development of superior content in the casino gaming business. For its Lottery business, this will necessitate the development of new sales channels

and more innovative ways of running lottery games. We believe that much of these new marketing efforts should be done online, through the establishment of better sales channels for lottery tickets online, as well as targeted placement of lottery ticket advertisements within mobile applications, wherever these meet legal requirements. In its Gaming Business, Scientific Games will need to focus on the development of superior, interactive gaming content in casinos and expand its presence in the mobile gaming industry as smartphone demand continues to increase among end-consumers. Sophistication of casino gaming products have lagged far behind non-casino video gaming products in the last fifteen years, and we believe that a failure to address this disparity will hurt SGMS' business in the long-term. In order to attract younger customers to the casino gaming business, it will be necessary to develop more advanced content that is similarly entertaining to non-casino based games. To this end, we believe that Scientific Games should focus its hiring efforts on engineers trained in software and video game development.

SGMS' second major strategic issue is that it needs to develop stronger relationships with its clients, especially governments in the lottery business and casinos in the gaming business. These clients, the middlemen between end-consumers and Scientific Games Corporation in both of its business lines, currently have a high degree of bargaining power over the company, and can easily take their business to SGMS' competitors if the company fails to meet their demands. Scientific Games should reduce this risk by working to control more of the value chain within both industries, handling as much administrative and monitoring work as possible to making the corporation indispensable to clients. We believe that such a strategy can be successful if SGMS highlights the benefits that accrue to its clients – namely, smoothness of operations and reduction of administrative costs and contract issues that would come with the move to a single supplier.

We are confident that Scientific Games Corporation can thrive in a changing and difficult business environment. Our detailed recommendations to CEO and President David L. Kennedy are contained in the following report.

Company Background

History

Established in 1973, Scientific Games Corporation (SGMS) immediately saw and took advantage of an opportunity in the lottery market. At the time, only thirteen states operated lotteries, and these were small, unsophisticated back-office operations. Beyond this, larger lottery networks tended to be run by organized criminal groups – the lottery had not yet become the prominent state-run enterprise that it is today.¹ In 1974, the company printed the world's first secure instant lottery game and introduced retailer validation codes to ensure the legitimacy of tickets, and by 1978 it had developed a system for lottery accounting and validation. These developments hugely increased the popularity of instant lottery games nationwide, and led to the adoption of SGMS' technology in many states throughout the decade.

In 1981, Scientific Games was acquired by Bally Manufacturing, the world's oldest slot machine manufacturer. SGMS continued to operate as a wholly-owned subsidiary under Bally, and created an integrated software package for accounting, distribution, marketing, inventory control, and ticket validation in 1984. Later that same year, it launched the first multi-state lottery in the U.S., and in 1986 it proceeded to set up the first touch screen, self-service kiosk for lottery tickets. After a decade of success in the 1980s, management at SGMS had enough money to purchase the instant lottery business back from their parent company, Bally Manufacturing. In 1993, Scientific Games completed a successful initial public offering, raising capital to further expand operations. Through the rest of the 1990s, SGMS continued to innovate in the lottery business, creating new imaging techniques on lottery tickets and inventing a hybrid lottery game, combining instant and draw lottery games.

In 2000, SGMS was wholly acquired by Autotote Corporation, which took on the Scientific Games Corporation name and stock ticker. In 2002, the newly formed company debuted the industry's first Virtual Private Network (VPN) telecommunication system to enhance communication abilities and flexibility between central systems and lottery terminals. The company completed a series of mergers and acquisitions in the early part of the decade and

¹ http://www.nytimes.com/2007/10/21/business/21machine.html?pagewanted=3&_r=1&exprod=delicious&

expanded outside of the U.S., gaining a foothold in the Chinese market through the China Sports Lottery. From 2010 onward, the company has expanded into markets in Mexico, the United Kingdom, and the European Union, usually through acquisitions of companies based in local countries. Most recently, in 2013, SGMS completed a \$1.5 billion buyout of slot machine maker WMS Industries, signaling its intention to increase the size of its gaming business. The acquisition will allow to SGMS to utilize WMS' significant casino video gaming capabilities in addition to SGMS' own production. Today, Scientific Games is a leader in the lottery and gaming businesses, boasting a market capitalization of nearly \$1 billion.

Five Forces Analysis

Porter's Five Forces Summary	
Force	Strength
Threat of New Entrants	Low
Threat of Substitutes and Complements	Low-Medium
Bargaining Power of Buyers	High
Bargaining Power of Suppliers	Medium-High
Intensity of Industry Rivalry	High

Threat of new entrants

High initial capital expenditures are a major barrier to entry in the lottery market, as it is expensive and difficult to produce and maintain lottery printing facilities and monitoring systems. Scientific Games has achieved economies of scale in production and already captures a large share of U.S. lottery market share, having secured contracts in 40 out of 44 jurisdictions in which lotteries are legal. Lottery monitoring systems require a high degree of engineering and computer skill to build and maintain, making it difficult for new entrants to challenge a dominant player in this market. Scientific Games provides its lottery systems based on five-year contracts, allowing the company to lock down market share in the short-term while it improves technology for long-term use.

Despite tight regulation of the lottery and gaming industries in the past, recent legal trends both in the U.S. and abroad have been in the direction of deregulation. Lotteries are now legal in 43 of 50 states and commercial gambling is legal in 21 out of 50 states in the U.S. Some regulation is actually beneficial to Scientific Games. For example, under the North American Free Trade Agreement, it is illegal for competitors based in foreign countries (except Canada) to import lottery games into the U.S. This protectionist policy significantly reduces the threat of foreign competition in SGMS' domestic lottery business and acts as another major barrier to entry.

Scientific Games Corporation has achieved economies of scale in its lottery business, operating five instant lottery game printing facilities across four continents. The facilities have an aggregate capacity to print in excess of 46 billion 2" by 4" equivalent standard instant lottery tickets annually. Smaller companies lack these production capabilities, a significant impediment

to their ability to compete in a paper-based business. Scientific Games' technological capabilities insulate it from the threat of new market entrants and the trust it has built in over 40 years of business with clients will make it difficult for new firms to gain market share, especially in the short-term. To maintain this competitive advantage, Scientific Games devotes significant resources toward the development of new technology for lottery games and systems.

Scientific Games attempts to bundle the design and manufacturing of instant lottery games, game management systems, marketing, and other services in contracts so as to increase switching costs for its customers. While some of their contracts in the lottery business are fully bundled, revenue in the gaming business is generated from contracts with unbundled services. Gaming service contracts can be terminated at any time, and a majority of the revenue in this business is generated from a high volume of one-time transactions, not long-term contracts. Because SGMS' customers in the gaming business are not locked in by long-term contracts, it is more likely that new entrants can make attractive deals and win market share in this business than in the lottery business.

Scientific Games already supplies instant lottery games to 40 of the 44 U.S. jurisdictions that sell instant lottery games, as well as to customers in over 50 different countries, making it difficult for new firms to distribute any products they may develop. U.S. instant lottery game contracts usually have an initial term of three to five years and contain multiple renewal options for additional periods, securing short-term revenue streams and providing an opportunity to develop long-term client relationships. In the United Kingdom, four large bookmakers operate approximately 86% of the licensed betting offices. Though one bookrunner has exclusive contracts with one of SGMS' competitors, SGMS has long-term contracts with two others, lasting until and 2017 and 2019. In this area of the U.K. gaming market, Scientific Games will benefit from customer loyalty for the near future.

Threat of Substitutes and Complements

End-consumers of gaming products do not have a high propensity to substitute for other products. Legal restrictions on gambling reduce the number of betting options available to the public, making it difficult for casino patrons to find effective substitutes for gaming products

they dislike. However, despite the lack of perfect substitutes for casino gaming products, we believe that SGMS may face competition in its gaming business from producers of non-casino video games. Though it is difficult to replicate the monetary aspect of casino gaming, normal game producers may be able to win over potential casino patrons with superior entertainment options. While this threat may not hurt SGMS much in the near future, we believe that other types of gaming and entertainment may become more effective substitutes for casino gaming in the long-term.

Certain types of gambling activities can act as both substitutes and complements for lottery games. Lottery games that are considered less fun or lucrative can be substituted with gambling activities such as casino gaming, betting on horse racing, or betting on bingo, and a host of other activities. However, many lottery users also enjoy participating in casino gaming, allowing the two businesses to complement each other. Increasing the number of lottery products available in states can help to increase the demand for all lottery and gaming products available in a jurisdiction. In jurisdictions that have legalized lottery games but do not allow gambling, it is more difficult for end-consumers to find effective substitutes. For non-lottery gaming services there are a number of substitute products available in the market. As we discuss further in the industry rivalry section, over twenty-five major worldwide players produce a variety of gaming products. Scientific Games' sources of revenue that are not locked in by long-term contracts face a far more difficult competitive landscape from a variety of effective substitute options.

Bargaining Power of Buyers

Within its Gaming segment, Scientific Games sells products and services to a variety of customers, including tribal casinos, riverboat casinos, horse and greyhound racetracks, bars, Jai Alai frontons, truck stops, nightclubs, bingo, and arcade halls. Scientific Games relies heavily on casinos to purchase its electronic gaming machines and game content and sports betting technology. If the demand for gambling in casinos drops significantly then the casinos will not renew their contracts with Scientific Games. Demand for casinos is driven by a number of external factors, including broad economic conditions, disposable incomes, fuel prices, and travel expenses. Because the installed base of gaming machines in the United States has

exhibited very low growth in recent years, much of Scientific Games' revenue is driven by casino demand for gaming machine upgrades. Therefore, SGMS' Gaming revenue is highly dependent on the rate at which casinos replace gaming machines, which in turn depends on end-consumer demand for casino gaming products.

Lotteries in the United States operate under state-mandated public procurement regulations. Lottery systems are evaluated on the quality of product and technical solutions, security plan and features, quality of personnel and services to be delivered, and price. Most lottery contracts are awarded through a formal bidding process, in which lottery system clients (usually governments) exert significant pressure to lower prices. It is common for selection of lottery system vendors to be based entirely based on price considerations. In both the Lottery and Gaming businesses, Scientific Games engages in cutthroat price-based competition. Its customers have a high degree of power over pricing and are able to dictate terms and negotiate prices downward.

Bargaining Power of Suppliers

Scientific Games' main inputs for its instant lottery manufacturing operations are paper and ink. These are very basic inputs that can be sourced from a large number of global producers. Once these inputs are acquired, Scientific Games' facilities print, package, and distribute the instant lottery tickets. We do not expect SGMS to have any difficulty in the procurement of paper and ink, and we believe that its suppliers for these materials exercise little, if any sway, over SGMS' input costs. For its production of lottery systems and gaming terminals, Scientific Games uses a variety of materials such as metals, plastics, wood, glass, and smaller component parts including electronic subassemblies, computer boards, and LCD screens. Markets for many of these materials, especially the electronic and metal components, are dominated by large state-owned firms or by multinational corporations, both of which have considerable power to dictate prices. Scientific Games also relies on third-party vendors to manufacture and assemble equipment, leaving the company vulnerable to price increases that may be decided by these manufacturers.

Because Scientific Games does not handle much of its own production, it risks having inadequate inventory if any suppliers or manufacturers fail to meet performance or quality

standards. The production of instant lottery games requires significant quantities of raw materials, supplies, power, and natural resources, much of which is sourced from outside of the United States. Suppliers have significant power over Scientific Games because the company is locked into long-term contracts and may not be able to find substitute suppliers quickly enough to meet demand. For example, the lead time for obtaining most of the electronic parts that Scientific Games uses in production of lottery systems and gaming terminals is approximately 90 days. This means that SGMS must plan out supply arrangements far in anticipation of needs, placing a priority on stable planning and reducing its ability to react to unforeseen events, such as sudden price increases or the availability of better options in the market for its inputs.

Intensity of Industry Rivalry

The casino gaming business is a highly competitive market with intense price-based competition. There are over twenty-five multinational companies that manufacture gaming machines for legalized gaming markets. Scientific Games' two main competitors in the United States are Pollard Banknote Limited and Gtech S.p.A. Among these companies, seven (GTECh S.p.A., Loto-Quebec, Konami Corporation, Novomatic AG, Itralot S.A., Universal Entertainment Corporation, and Scientific Games Corporation) had revenue of over \$1 billion for FY 2013. Despite the relatively high firm concentration ratio, we believe that all of these companies pose a serious competitive threat to SGMS, as even the smaller companies may have distinct competitive advantages in certain markets.

Scientific Games also faces stiff competition in its lottery systems businesses. Government-run bidding processes make lottery price negotiations extremely price-driven, decreasing SGMS' ability to sell higher quality products at higher prices. There are many successful players in this market - while Scientific Games is the second largest supplier of lottery systems in the United States, it only has contracts to sell lottery systems in 10 of the 45 jurisdictions that operate draw lotteries. Intense price-based competition makes it difficult for Scientific Games to gain a lasting competitive advantage. For the most part, governments find that the benefits they gain from purchasing more sophisticated lottery systems are outweighed by the higher cost of such products.

Financial Analysis

Overview

Overall, Scientific Games Corporation has struggled financially over the past five years. The company has struggled with high debt levels, a problem aggravated by SGMS' recent entry into a new \$2.6 billion credit line, which has increasing total liabilities to \$3.87 billion, compared to total assets totaling \$4.24 billion.² This problem of very high leverage is underscored by the company's debt to equity ratio of 8.51, over four times that of its closest peers. Though the remaining metrics may be skewed by the recent \$1.5 billion merger with WMS Industries, SGMS has consistently posted negative ROE and slightly negative EPS over the past five years. Moreover, they have lost over \$40 million to bad debt and doubtful accounts over the same time period, adding to the fundamental financial issues on their balance sheet.

	Scientific Games (SGMS)	GTECH (GTKYY)	International Game Technology (IGT)
Market Cap	1.00B	3.89B	3.32B
Net Income	-25.60M	227.13M	286.60M
P/E	N/A	22.81	12.28
Current Ratio	2.1	1.11	1.08
D/E	8.51	1.05	1.99
EPS	-0.36	1.31	1.1
Beta	1.92	N/A	1.46
EBITDA	239.60M	1.31B	778.30M
ROE	-8.16%	8.82%	23.33%

Stock Performance and Analyst Expectations

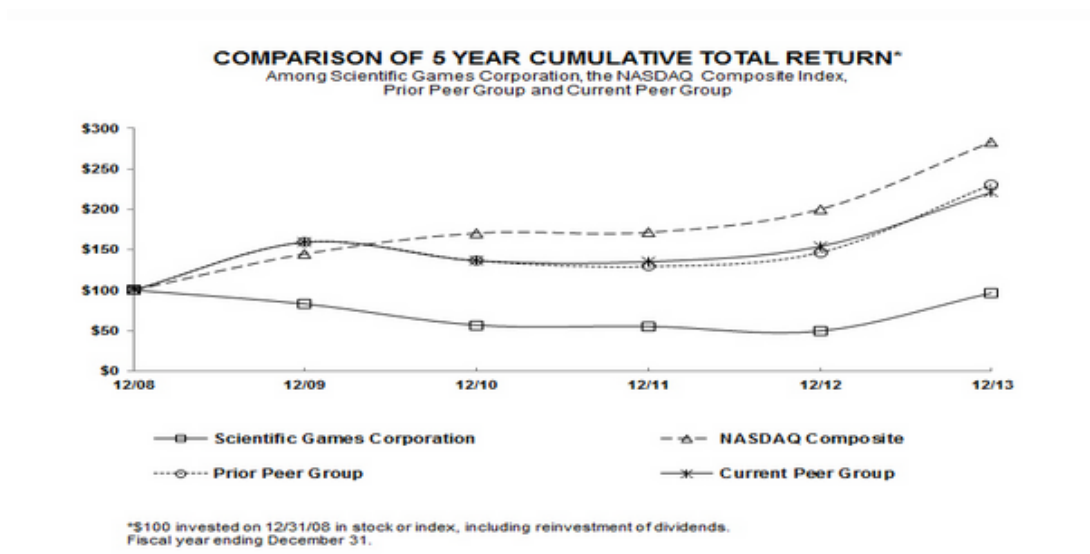
Scientific Games Corporation went public in 1993, trading on NASDAQ under the ticker SGMS for \$11 per share. The stock price initially skyrocketed amid investor enthusiasm, but crashed within two years to pre-IPO levels and remained at approximately \$2 per share until 2001. Leading up to the 2008 recession, the price reached a high of \$39.15, only to plummet to a low of \$6.77 in 2010. The stock remained around this price until 2013, when it more than doubled following the announcement of its WMS acquisition. Scientific Games only outperforms its

² <http://www.prnewswire.com/news-releases/scientific-games-completes-acquisition-of-wms-228325541.html>

competitors over a one-year window; GTECH tends to show the most growth over longer horizons, despite a 3-month stock flatline when the company changed its ticker symbol.



Likewise, the performance graph provided in Scientific Games' 10-K (see below), which includes a larger group of industry peers, doesn't paint a positive picture of the company's stock performance. Scientific Games consistently underperforms when compared to two different peer cohorts and the NASDAQ.

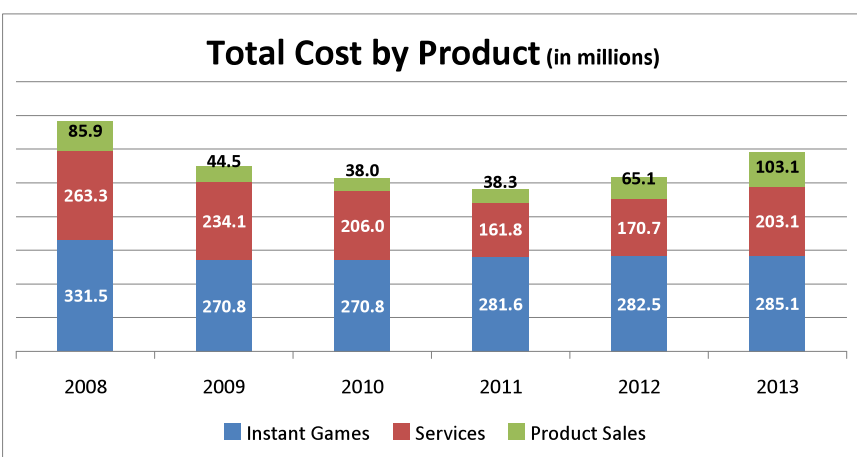
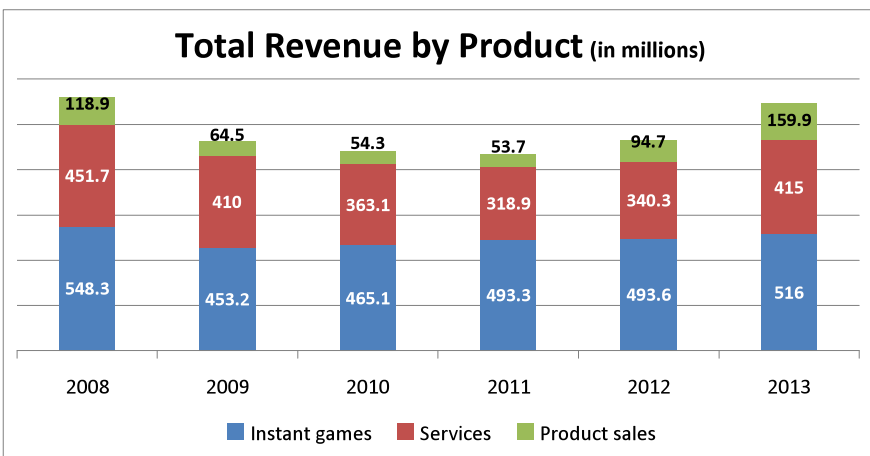


Clearly, Scientific Games' share performance has been weak over the past five years. Of the six equity research analysts who cover SGMS, opinions have been divided almost evenly across buy and sell recommendations. After its recent merger with WMS, a majority of analysts rated SGMS as a buy, predicting that the stock will appreciate substantially as newly combined company achieves cost savings and business growth. Because industry experts are generally optimistic about this acquisition, a majority of analysts predict that Scientific Games will finally become profitable after years of posting negative net income. CNN Money's analysts, for example, predict a median growth of 49.5%, with a high of 82.7% and a low of -41.9%.

Revenue, Profitability and Growth

There is a disconnect between Scientific Game's product lines and how revenue is reported. While the company breaks down its business lines into three different segments, Instant Products, Lottery Systems, and Gaming, it sorts financial information under three different categories called Instant Games, Services, and Product Sales. While Instant Games and Instant Products are equivalent, revenues reported as "services" and "product sales" could come from either the Lottery Systems or Gaming departments. Therefore, the company's disclosed financial may not provide a completely accurate picture as to the health of each of its main business segments.

The graphs on the following page show the respective contribution of each of these groups to overall revenues and costs.



These graphs show that revenue and costs have fluctuated over the past five years, dropping for the first four years and then climbing back up, both skyrocketing in 2013. It is worthwhile, then, to look at trends within the specific products to try and understand some of these movements.

Instant Products

Instant Games refers to Scientific Games' instant lottery ticket sales business. The company receives revenue from this segment in three ways: manufacturing and selling tickets; supplying additional services, such as "game design, sales and marketing support, specialty games and promotions, inventory management, and warehousing and fulfillment services"; and sublicensing their brands.³

³ Scientific Games 10-K, pg. 52

Overall, Instant Game revenue has increased consistently since 2009. Its revenues and costs have over the last few years. While Services and Product Sales revenues have grown 28.7% and 145.2%, respectively, in two years, Instant Games has seen an increase of only 4.6%.



Three indicators—participation contracts, price-per-unit contracts, and licensing and player loyalty—contribute instant game revenues, though historically there has not been a direct correlation between any one of these metrics and revenue. According to the chart below, the company sees a growing portion of its revenue in this area coming from participation contracts, and a dwindling number from price-per-unit contracts. This is perhaps the source of stymied growth in this area – the company may have saturated the contract market, and so their clients may simply be switching between contract types. If this is the case, Scientific Games should push clients towards the contract with the higher profit margin as soon as their contracts expire.

Revenue as a % of Total Instant Game Revenue			
	2013	2012	2011
Participation contracts	49%	49%	43%
Price-per-unit contracts	39%	41%	44%
Licensing and player loyalty	11%	9%	13%

It is also important to note that the company is making a concerted effort to expand its Instant Games services abroad. Scientific Games signed a contract with the Lottery of Panama in October 2013, with Loto-Quebec in January 2014, and with a lottery distributor in Mexico in

February 2014. The majority of Instant Game revenue (61%) still remains in the United States, but this number is just beginning to decrease.

Lottery Systems

The Services department is “a leading provider of customized computer software, software support, equipment and data communication services to lotteries.”⁴ Essentially, clients receive integrated support throughout the duration of their contracts, which usually last for 5 years, in exchange for a percentage of the lottery’s total retail sales.

It is unclear whether Lottery Systems is more directly related to Services and Product Sales (the categories used in the financial reports) than Gaming, and so the graphs for these two financial metrics will follow these product descriptions.

Gaming

Scientific Games’ Gaming branch is responsible for designing, manufacturing, distributing, and marketing “gaming machines, VLTs, server-based gaming machines, systems and game content, video lottery central monitoring and control systems and networks, and interactive products and services.”⁵

Generally, companies enter into contracts for at least 5 years with Scientific Games. With these contracts, Scientific Games receives revenue for the equipment, which includes either a gaming machine—new or used—or a video lottery terminal (VLT) and a conversion kit, which is used for hardware or software conversions for the game. The company also recognizes revenue by leasing gaming machines or VLTs under operating leases, fixing broken machines, and supplying new parts.

⁴ Scientific Games 10-K, pg. 85

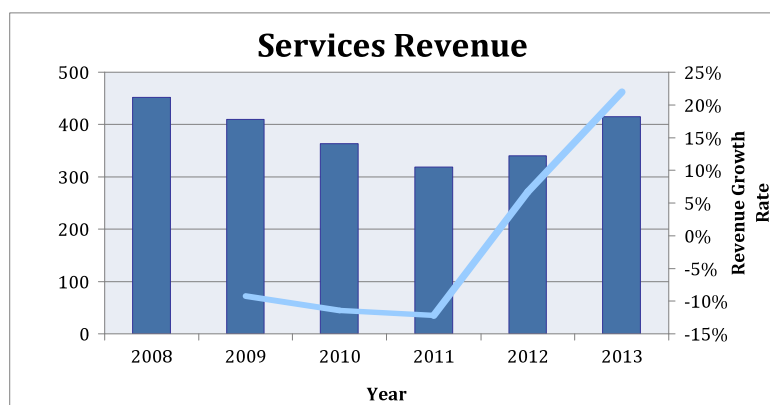
⁵ Scientific Games 10-K, pg. 85

The game content, which Scientific Games maintains remotely, is paid for using one of the following contracts:

- A percentage of the casino or gaming operator’s net win,
- A fixed amount per day,
- A percentage of the amount wagered (coin-in), or
- A combination of the daily fee and a percent of the coin-in.

Scientific Games also receives revenue from non-wagering social games—which are available for play on Facebook, for download on the iOS, Android, and Kindle platforms—and on “third-party online real-money gaming websites,” which are integrated with the company’s remote servers.⁶

Services and Product Sales Growth



Like with Instant Games, the revenues for these categories decreased for the first four years, and then experienced positive growth for the last two. It is important to note, however, that each of

⁶ Scientific Games 10-K, pg. 85

these three segments experienced their highest growth period at different times. Instant Games peaked at 6.1% growth in 2011, Services at 22% in 2013, and Product Sales at 76.4% in 2012. This suggests it was not simply one macro event that helped the company's revenue recover, but rather a concerted effort on the part of the management to improve profitability in each of these areas.

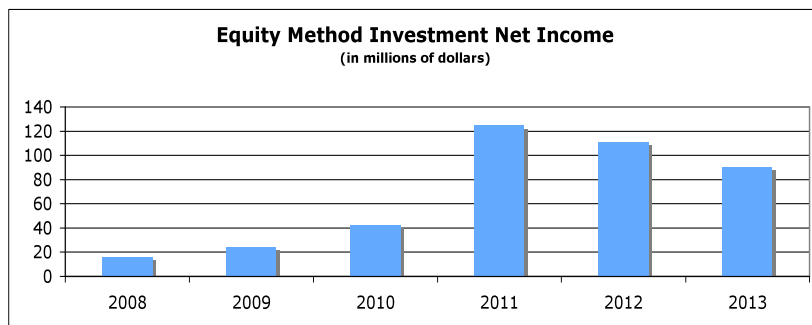
Equity Method Investments

Scientific Games has an additional revenue source from its Equity Method Investments; essentially, the company buys 20% stakes in smaller gaming and lottery companies to hedge its risk of a changing market environment. The company describes its motivation:

As U.S. and international jurisdictions increasingly look toward lottery and gaming as a source of revenue growth, we believe there may be interest in pursuing an outsourcing model whereby the day-to-day management of lotteries is conducted by a third party, similar to the PMA model in Illinois or New Jersey. To the extent any of our lottery customers enter into a PMA, such lottery customer or the private manager may terminate our existing contract(s) as part of the transition to the private management model. To date, we have largely pursued these opportunities by making strategic equity investments in the private manager or outsourced service provider and entering into lottery supply agreements with such private manager or provider.⁷

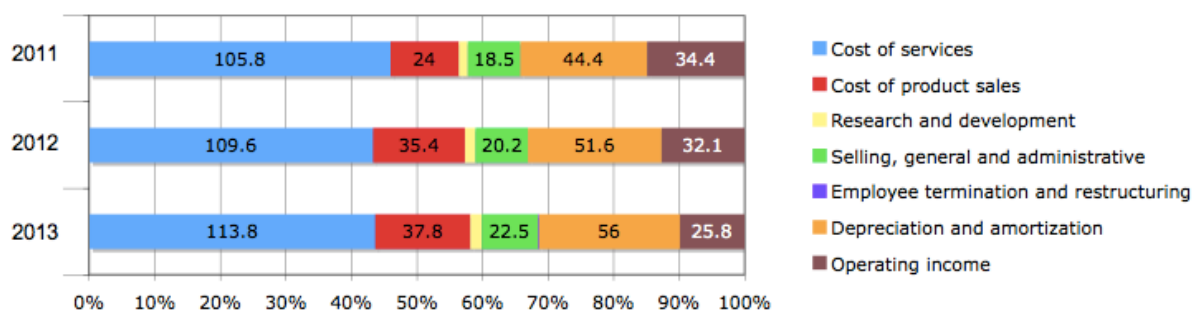
In its efforts to diversify into these managerial firms, Scientific Games has invested in LNS (Italy), Northstar Illinois, Northstar New Jersey, CSG (China), and Hellenic Lotteries (Greece), all of which are included in the Instant Products revenue calculations. These investments are expected to constitute a large portion of future revenues in this segment, and therefore revenue streams will ultimately be reliant on the performance of outside companies (shown in the graph on the following page).

⁷ Scientific Games 10-K, pg. 53



It is unsurprising net income has fallen over the last few years, given that one of the portfolio companies has had recent legal troubles. The penalties they paid as a result drastically decreased their profitability and therefore Scientific Games' revenue stream.

Costs



Overall cost growth for Scientific Games has been slowing in recent years, likely due to falling operating costs and technological advances in video game terminal and lottery system production. We expect that costs will continue to fall as SGMS achieves significant cost savings and better economies of scale from its many recent mergers and acquisitions.

SWOT Analysis

Strengths:

- As a leading player in the lottery and casino gaming industries, SGMS has developed customer relationships and a strong reputation.
- SGMS has a worldwide presence, with a foothold in fifty different countries
- The company sells a wide variety of products in both its lottery business and casino gaming businesses.

Weaknesses:

- Aggressive expansion through mergers and acquisitions raises questions of successful merger integration.
- SGMS depends on a small number of customers for a large portion of its revenues in its lottery business.
- Difficult to predict demand in the gaming industry – casino needs are driven by many factors outside of SGMS' control and the market is saturated with suppliers.

Opportunities:

- In both its lottery and gaming businesses, looser regulation provides the opportunity to penetrate new geographies and gain a dominant market position in those areas
- Within the gaming segment, SGMS can develop a stronger presence on Facebook, Android, and Apple platforms
- SGMS can increase the sophistication of its gaming products in order to make them more interactive and appealing to consumers.

Threats:

- Regulatory issues – stiffening of regulation means SGMS will lose business, but even lightened regulation can open SGMS up to more competition.
- Highly price-competitive gaming markets expose SGMS to significant competitive risk if competitors are able to cut costs more quickly than it can.
- Financial issues – 49% of revenue comes from outside of U.S., where it is harder to predict business conditions, and 25% of stock is held by one shareholder.

Strengths:

Scientific Games Corporation (SGMS) has been active in the lottery industry since its inception in 1973. Over the last 41 years, it has established itself as a worldwide player in producing the two most popular type of lottery games – instant products and draw lottery games, which accounted for \$76 billion and \$199 billion in revenue in 2012. SGMS does business in forty of the forty-four U.S. jurisdictions in which lotteries have been legalized, and it has clients in fifty different countries across the globe. The company enters into three to five year contracts, ensuring that its operations are not significantly impacted in any one year by unforeseen developments. Governments run lottery games as a way to raise additional revenue from willing participants without imposing taxes and as such, the industry will likely be a stable one for years to come. Because governments have an interest in ensuring that lottery products are created and disseminated responsibly, it is important for lottery producers to have a demonstrated record of success and strong brand reputation in order to win business. We believe that SGMS, as one of two pioneers in the creation of the state-sponsored corporate lottery enterprise, is exceptionally well positioned in this regard.⁸

SGMS also has well-established operations in the gaming industry, which includes the production of video games in casinos and arcades, slot machines, and computerized wagering systems for sporting events such as horse races. In October 2013, the company completed a \$1.5 billion merger with WMS Industries which will significantly expand SGMS' presence in all of these markets – especially slot machines, of which WMS was the third-largest global producer. The merger will enable SGMS to diversify its revenue sources even more, ensuring that the company as a whole is not vulnerable to market shocks in any one of its business areas. In addition, it allows SGMS to use WMS' advanced research and development operations to markedly upgrade its own technology in the casino video-gaming business, which the newly formed company (still called SGMS – WMS will be a wholly-owned subsidiary) believes will be an area of significant growth in the coming years.

⁸ http://www.nytimes.com/2007/10/21/business/21machine.html?pagewanted=3&_r=1&exprod=delicious&

Weaknesses:

The company has pursued a strategy of expansion through the purchase of smaller companies abroad. Recent acquisitions include the 2006 purchase of Global Draw, a leading supplier of server-based gaming terminals and systems in the UK, the 2007 acquisition of 50% of Guard Libang, a leading provider of instant lottery cooperatives services in China, and the 2012 acquisitions of Provloto in Mexico and Parspro in Europe, both of which have sports betting and lottery operations. These are just a few examples of the company's acquisitions, most of which are outright cash buyouts of below \$50 million. SGMS' overseas expansion in the past decade raises questions of whether it can successfully integrate the acquired companies into its larger business and whether it can operate successfully in foreign markets. In particular, it remains to be seen small acquisitions in foreign countries, especially in markets like China, are a stepping stone to future growth. Because the people with the most knowledge of these foreign markets tend to be concentrated within the companies that are acquired by SGMS, SGMS is dependent on its subsidiaries' executives in a way that it may not be if it pursued a more organic growth strategy.

In addition, the recent merger between Scientific Games and WMS Industries, valued at \$1.5 billion, represents a fundamentally different type of corporate consolidation. Unlike the other companies that have become a part of the SGMS umbrella, WMS is a very large player in the gaming industry and will account for a significant portion of the combined company's revenues. It will be a challenge to successfully integrate the two companies and minimize the amount of clashes regarding corporate strategy and company culture. In addition, Scientific Games will need to determine areas in which it can achieve synergies and cut costs, which tend to be the expected benefits from mergers and acquisitions. This requires a careful analysis of the new company's operations and must be done efficiently and delicately to ensure that vital positions are not cut and at the same time, ensure that staff are not alienated by what may be perceived as unnecessary cost cutting.

Because of the nature of the gaming business, the majority of Scientific Games' sales within this business segment are to casinos. End consumer demand for casino products is variable and can depend on a variety of factors, including broad economic conditions which affect disposable

income. Because casinos are only legal in certain jurisdictions, consumers must travel in order to use SGMS' products, so SGMS' revenues have historically been affected by travel costs and fuel costs. A significant portion of SGMS' gaming revenue comes from upgrading video gaming machines in casinos every three to five years, but demand for upgrades is driven entirely by casino needs and the market is saturated with suppliers. As such, casinos have a high degree of buyer power over SGMS in the gaming segment of the business.

Scientific Games derived approximately 43% of its Instant Products and Lottery Systems revenue in 2013 from thirteen contracts in the U.S., Europe, and Canada. Though these tend to be long-term contracts (around ten years on average), SGMS lacks a truly diversified revenue stream within this segment of its business. While the company has in the past been successful at renewing most of its contracts, one of these thirteen contracts expired in January 2014 and was not renewed. If this trend continues, SGMS could experience a major decline in revenue in one of its most important business segments.

Opportunities:

Because the lottery and gaming businesses are highly regulated, Scientific Games faces many regulatory and legal issues wherever it has operations. In recent years, liberalization of lottery and gaming laws in areas such as the European Union and China have allowed Scientific Games to begin expansion into these markets. Because governments can gain revenue from the operation of lotteries and from taxation on casino revenues, cash-strapped governments are likely to continue the worldwide trend towards looser restrictions on lotteries and gaming. This presents a huge opportunity – if SGMS can expand into new markets and develop long-term relationships with governments and casinos, it stands to gain dominant market share in these markets for years to come.

SGMS currently derives the majority of its gaming revenue from casino-based video games and mechanical reel gaming machines. In these games, casino patrons wager on their performance or specific outcomes. These include local-area progressive games, in which casino patrons bet on jackpots that are formed within their own casino, and wide-area progressive games, in which users from different casinos can all participate in one game, where they all contribute to and

stand to earn payouts from a larger jackpot. While such games are still popular, they may not be the future of gaming. Computer games and mobile games and applications have gained popularity in recent years, and such games may become a more popular substitute for casino based video games. SGMS currently hosts the *Jackpot Party Social Casino* on Facebook, Apple, Android, and Kindle platforms, in which the company sells virtual coins to customers who are in turn allowed to use these to play on physical slot machines. The company also serves real-money gaming website operators in Europe, allowing them to use SGMS games and splitting revenues. We believe that there are significant opportunities for expansion in the mobile gaming sector and we think that SGMS stands to gain from creating content for mobile and Facebook platforms. These can include casino-style and lottery-style games with virtual coin sales, but we believe the company should also produce non-casino mobile games for which they can sell additional features for real money.

SGMS can also carve out a niche for itself in the casino gaming market by creating more sophisticated and interactive gaming content. Currently available products for casino gaming are not widely differentiated, meaning that casinos are able to pressure game makers to compete on price. The technological advancement and sophistication of casino video games has lagged behind the advances in non-casino video gaming technology, but that if SGMS can create more sophisticated games for casinos, it will be able to a higher degree of power over its buyers. We are confident that SGMS can hire developers from non-casino video game companies in order to create more interactive content for its own gaming segment and we believe that this is a major opportunity for product differentiation in the gaming industry.

Threats:

While Scientific Games stands to gain in many ways from the liberalization of regulations on the gaming and lottery industries, it also faces a multitude of threats from any legal developments. Because lotteries are generally operated in cooperation with local governments on a revenue-sharing basis, SGMS stands to lose revenues if governments change the structure of these revenue-sharing agreements. If a jurisdiction chooses to outlaw gaming, SGMS must shutter its operations in the area and stands to lose large amounts of money. But it is not just tightening of regulation that poses a threat to SGMS. Easing regulatory burdens opens SGMS to competition

from well-established market players, such as large competitors Gtech S.p.A and Bally Technologies, as well as smaller local players. While SGMS may be able to begin business in newly liberalized international jurisdictions, it may not be able to respond as quickly to localized customer preferences or changing market dynamics as quickly as smaller, more localized gaming companies might. SGMS' rapid international expansion and the scope of its operations may be a liability in such a scenario. Because the lottery and gaming industries are tightly regulated, any change in the status quo can be as much of a threat as it is an opportunity.

Since SGMS operates in well-established markets with a host of large and small competitors, it faces stiff price competition in every segment of its business. This puts constant pressure on the company to maintain efficiency and reduce costs of production for its video gaming machines and its lottery technology systems. If other companies are able to cut costs or develop stronger research and development operations, SGMS will lose competitiveness in an already tight market with heavily price-based competition. Therefore, the company must either consistently find ways to cut costs, or to ensure that it offers differentiated products that customers will demand regardless of price. Because both of these are difficult to achieve, we believe that industry rivalry and price competition are major threats to SGMS' business.

We also worry that Scientific Games may be affected by volatile international revenue streams. In 2013, the company derived 49% of its revenues from international jurisdictions, where it is more difficult to anticipate regulatory developments. Lottery markets and gaming markets are very well established domestically, and SGMS operates in virtually every major lottery and gaming jurisdiction within the United States. However, many international jurisdictions have only recently been opened to U.S. gaming and lottery companies, and we worry that it will be difficult to predict developments in many of these markets. Finally, we note that one shareholder owns 25% of SGMS' common stock. We believe this presents a threat to the long-term success of the company, as this shareholder may exercise undue influence over the company's decision-making, influencing it to go down paths to maximize short-term earnings at the expense of long-term strategic decision-making. While this shareholder has not demonstrated a track record of irresponsible behavior, we believe that its disproportionate power can be potential threat to the long-term performance of the company.

Strategic Recommendations

Because the lottery and gaming industries are fundamentally different, we break down our recommendations according to business segment.

Lottery Strategic Recommendations:

- Focus on product enhancement – more depth, less breadth.
- Create new sales channels for lottery games, especially for direct sales to end customers.
- Manage more aspects of the lottery value chain.
- Continue geographic expansion to take advantage of loosening regulation

Scientific Games currently offers over 30,000 instant lottery games, the most of any company in the lottery industry. We believe that the company stands to gain by enhancing the quality of its lottery content instead of simply producing more games. It can accomplish this by developing rewards programs and creating players clubs in order to encourage higher lottery participation, especially from repeat customers. In addition, SGMS should focus on improving its centralized management systems for lotteries to ensure that it is able to break away from purely price-based competition within the lottery industry. We suggest that the company cut some of the costs associated with research and development for new lottery games and focus this spending on improving the technology that forms the backbone of lottery management systems.

Beyond product improvements and the establishment of customer rewards programs, SGMS should make efforts to attract more customers by establishing new sales channels. Currently, lottery products are sold primarily through retail outlets, bars, and restaurants. Scientific Games should invest money in the development of direct-to-consumer sales channels, such as self-service lottery vending machines and Internet subscription services, which will make it more convenient for players to participate.

We believe that Scientific Games stands to gain by maximizing its share of the lottery value chain for its clients. This includes the management and administration of the lottery game itself, inventory, logistics, marketing, retailer recruitment, and a variety of other responsibilities.

Currently, Scientific Games controls only certain parts of the lottery value chain for a large portion of its customers. If SGMS is given more responsibility by its customers, it can gain a stronger understanding of end-customer lottery habits and preferences, thereby giving the company better information in order to create more custom-tailored lottery products and services. We suspect that while some of SGMS' customers will not allow for full company control of the lottery value chain, the decrease in administrative work achieved by contracting with only one lottery game supplier will prove motivation enough for many to cede more control to SGMS. If Scientific Games achieves more control of the lottery value chain, its products and advice will become even more valuable to clients, which will allow the company to forge long-term business relationships to lock in profits for the long-term.

Despite the regulatory risk associated with opening and operating lottery businesses abroad, we believe that Scientific Games should continue its strategy of overseas expansion. Lottery regulation has loosened considerably over the past forty years, and we expect that governments will continue to liberalize lottery legislation in the coming years. Because lotteries produce significant revenue for governments without the stigma of a formal tax increase, more governments have found lottery games useful as revenue producers.

Gaming Strategic Recommendations:

- Help develop products for regulators for monitoring and administrative purposes
- Focus on research and development to create superior video gaming terminals
- Expand further into mobile and internet gaming to keep pace with changing nature of entertainment and leisure

Given the regulated nature of the gaming business in jurisdictions across the world, casinos operate under significant government oversight. Scientific Games Corporation currently provides "Command, Monitor & Control Systems" (CMCS) to regulators in many jurisdictions where it operates. CMCS provide regulators the ability to monitor usage and earnings from many types of casino game, including basic slot machines, local-area video gaming terminals, and wide-area progressive gaming systems. Because regulation and monitoring are hallmarks of the gaming industry as a whole, we believe that SGMS should increase the sophistication of its

monitoring capabilities and make a concerted effort to increase product sales in this area. If gaming regulations become more stringent, hurting SGMS' ability to sell gaming machines, it is very likely that tighter regulation will increase government demand for CMCS. Thus, Scientific Games should take advantage of a very low-risk opportunity to meet a high demand by devoting more resources to the production of such technologies.

Scientific Games' recent merger with WMS Industries should significantly improve its business prospects in the Gaming industry. However, this alone will not ensure SGMS' survival in the extremely competitive casino gaming market – the new combined company will need to pursue strategies to create differentiated gaming products that are superior to those of its competitors. This is easier to accomplish in the gaming business than in the lottery business, as the gaming business is more entertainment-based than lotteries. In particular, the prevalence of video gaming terminals in casinos presents a major opportunity for SGMS. As one of the largest global producers of slot machines and video gaming terminals on which casino patrons can bet on game outcomes, Scientific Games has the ability to invest in technology improvements for its video gaming content. Specifically, the company should seek to create more engaging and interactive content to ensure that casino gaming does not lose market share in the entertainment business, which is seeing a move toward non-casino and non-arcade based video games. If SGMS does not invest significant resources in the creation of new, more interactive content, it will lose business, especially from younger potential casino patrons.

The increasing popularity of handheld electronic devices such as tablets and smartphones has fundamentally altered the dynamics of the consumer entertainment market. Though the general consumer entertainment is distinct from the casino gaming industry, trends in the wider entertainment market have an effect on gaming, especially in the long-term. In today's market of wildly popular smartphone apps and tablet games, we firmly believe that a gaming and leisure company such as SGMS must develop and execute a feasible mobile strategy. Scientific Games currently has a presence on Facebook, Apple, Android, and Kindle platforms, producing games in which customers purchase virtual coins in order to advance or gain special perks. These virtual coins are accepted in physical slot machines, allowing the company to gain revenue without actually transacting real money over the Internet, a practice which would likely be in

violation of gaming regulations. We believe SGMS should continue to develop these games and that it should also begin to produce mobile and laptop games that are not centered around gambling, for which they can charge real money for in-game upgrades. Such games are becoming increasingly popular, especially among teenagers and young adults, and we believe that it will be essential to appeal to this customer base to maintain long-term profitability.