

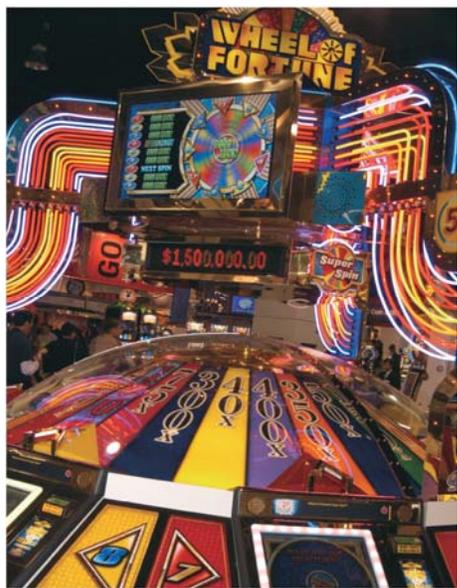


April 13, 2005

## *International Game Technology: We Like the Odds!*

### *Recommendation – Buy*

Current Price (4/13/05): \$25.10  
Target Price: \$30.71  
Upside: 21%  
52 Week Range: \$25.10-47.12  
Market Cap: \$8.66B



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- We are initiating coverage of International Game Technology Corporation (IGT) at \$25.10 with a target price of \$30.71.
- Overreaction by the market to a down quarter (1Q 05) has resulted in IGT trading at a 52-week low.
- IGT is an undisputed technological leader, with its strong balance sheet and commitment to R&D resulting in the industry's most innovative games.
- IGT's unique mix of gaming products and systems allows diversification of customers across gaming jurisdictions.
- IGT's economies of scale and scope position it to capture growth in International markets as the North American market matures.

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## Investment Thesis

We are initiating coverage of IGT with a Buy recommendation. Underlying this recommendation are five major investment points:

- **Technological Innovation—First to Market.** IGT has long been the first to market with new games. It spends nearly three times as much on R&D as its closest competitor. In 2004, it launched 180 new games—twice as many in 2003.
- **Revenue Mix—A Healthy Hedge.** IGT has revenue streams from both product sales and gaming operations. Combining this with its exposure to international growth and its market-leading North American edge, IGT is well diversified across all gaming markets.
- **Economies of Scope—Beyond Slots.** IGT's traditional dominance has been in slots, with 70% of North America's installed base of 800,000 machines. With the maturing of this market, it has made strategic acquisitions to move into a leadership position in casino management systems.
- **International—Putting the I in IGT.** In addition to diversifying into casino systems, IGT has also moved aggressively overseas. The international demand for gaming is growing at high rates. IGT has already begun to capitalize by establishing its International segment to target these customers. For the first quarter 2005, IGT has seen an 84% increase in revenue from international product sales over the same quarter in 2004. We expect IGT to thrive as the globalization of gaming markets accelerates.
- **Sales and Marketing—Making Size Work.** One of the most compelling sources of IGT's competitive advantage is the size and reach of its sales and marketing force. IGT has 4,900 employees in offices on five continents—dwarfing its competitors—giving it unmatched distribution channels to serve casino openings and expansions, strong ongoing relationships with the top casino operators, and the ability to “localize” products for international markets.

Based on our valuation, we believe that the market has overreacted to the company's 1<sup>st</sup> quarter results and that IGT is an attractive investment opportunity.

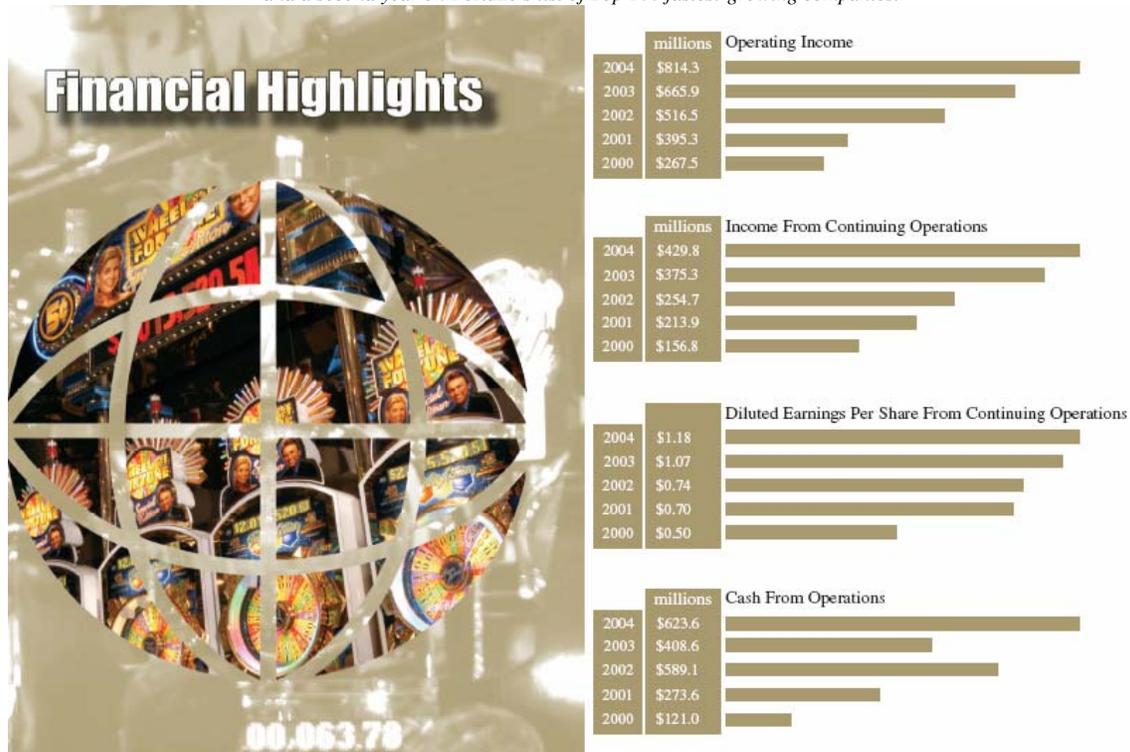
## Company Overview

International Game Technology (IGT) is a leader in the design, development, manufacture, distribution, and sales of computerized gaming machines and systems products in jurisdictions where gaming is legal. Products include traditional spinning reel slot machines, video gaming machines, government sponsored terminals, and other gaming devices.<sup>1</sup>

IGT has two revenue components: product sales and gaming operations. Product sales come from the sale of gaming machines, systems, parts, conversion kits, licenses, and royalties. Gaming operations are derived from IGT's installed base of recurring revenue games, such as through gaming equipment leasing. IGT has two regional operating segments, North American and International, which incorporate the relevant revenue sources from product sales and gaming operations.

IGT seeks to diversify its presence in gaming markets globally and broaden its product offerings. Founded in 1980 to serve the US gaming industry, the company began expanding beyond the US in 1986. In addition to its production facility in Reno, NV, the company manufactures products in the United Kingdom, and via third-party manufacturers in Japan and Canada. It maintains sales offices across the US, Australia, Canada, Europe, Japan, Latin America, New Zealand, South Africa, and the UK.

*IGT earned record revenues and sales in 2004, earning a No. 18 spot on Business Week's list of 50 best performing large companies and a second year on Fortune's list of Top 100 fastest-growing companies.*



Source: Company 10-K

<sup>1</sup> Company 10-K.

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Eight characteristics of the company link up our investment thesis and valuation.

### 1. Balanced Revenue Streams

Chairman and CEO Thomas T.J. Matthews, has made several important directional changes since assuming IGT leadership in 2003. Matthews has restructured its business around customer regions, and is beginning to expand the company's business beyond traditional slots and internationally.<sup>2</sup> IGT has two operating segments: the North America Division (86% of consolidated revenues in FY2004) and the International Division (14% of consolidated revenues in FY2004).<sup>3</sup> IGT has two revenue streams: product sales and gaming operations—a mix we view as an important diversification.

#### *Product Sales*

Product sales revenues come from sales of gaming machines, systems, parts, conversion kits, licenses and royalties, equipment, and services. Product sales revenues accounted for 53% of consolidated revenues in FY2004, compared with 50% in FY2003.

For the North America market, IGT makes a range of gaming machines, including traditional spinning reel slot machines, video gaming machines, and government sponsored terminals. Internationally, IGT focuses on the casino-style, private club, gaming hall, government sponsored terminal, and “pachisuro” or low-payout markets. The company sells game themes to customers directly or via distributors; offers equipment contract financing; and provides financing loans for facility expansion. Best-selling 2004 products included *Kenny Rogers*®, *Cops and Donuts*®, and *Lucky Larry's Lobstermania*®. Planned 2005 introductions include *Shake Your Booty*™, *Space for Rent*™, and *Stinkin' Rich*™.<sup>4</sup>

IGT has a dominant 68% share of total installed base of gaming machines, which the company attributes to a commitment to technological innovation and game design, patents, manufacturing, sales and customer service.<sup>5</sup> IGT also offers gaming systems products that enhance the gaming experience and give customers operational efficiencies. Examples of applications include bonusing, slot monitoring, and patron management. Helped by the company's acquisition of Acres, over 50% of North American gaming machines are now attached to an IGT system.<sup>6</sup>

#### Gaming products as a percentage of consolidated product sales revenues

	2004	2003	2002
Video & Spinning Reel	71%	74%	72%
AWP & Low Payout	10%	9%	11%
Parts & Conversions	9%	10%	11%
Gaming Systems	9%	6%	5%
Other Gaming Products	1%	1%	1%

Source: Company 10-K.

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<sup>2</sup> Christopher Palmeri, “IGT: In Search of the Next Jackpot,” *Business Week*, 14 February 2005.

<sup>3</sup> Company 10-K.

<sup>4</sup> Company 10-K.

<sup>5</sup> Company 10-K.

<sup>6</sup> Company 10-K.

### *Gaming Operations*

Gaming operations revenues are derived from the installed base of recurring revenue games. These are called recurring because they are based on the use of gaming machines and equipment distributed through participation agreements. This revenue stream accounted for 47% of consolidated revenues in FY2004, compared with 50% in FY2003. About 98% of gaming operations revenues comes from the North America Division.<sup>7</sup>

Recurring revenue games are distributed through arrangements such as wide area progressive (WAP) systems; stand alone participation and flat fee; equipment leasing and rental. WAP games, unlike stand alone games, are electronically linked systems that link games and allow the system to build a progressive jackpot. Participating casinos pay a percentage of “coin-in” to a trust to fund the jackpot or to IGT, which typically administers the funding (though this differs by jurisdiction). Thus WAP represents a revenue-sharing form of gaming operations.<sup>8</sup>

Factors influencing growth in gaming operations revenues include number of machines placed, geographic mix, and pricing. Factors influencing expenses include the cost of funding payments to jackpot winners (which is subject to volatility in interest rates). IGT’s proprietary games are characterized by features and themes. Popular themed games include *Wheel of Fortune*®, *Megabucks*®, and *The Price is Right*™. Planned 2005 themed introductions include *Star Wars*™, *Drew Carey*™, and *Gilligan’s Island*™. IGT recognizes that all games have a limited life cycle and replaces games with falling play levels with new games and brand extensions.<sup>9</sup>

IGT distributes proprietary games in 26 North American jurisdictions and international locations in Australia, Europe, Iceland, Latin America, and South Africa. The company has a 63% share of proprietary games installed in North America.<sup>10</sup> (IGT owned games show up as property, plant, and equipment; casino owned games are machines sold with a recurring royalty fee.)

<u>September 30.</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
<b>Recurring Revenue Games</b>			
IGT owned units			
Casinos	30,300	29,400	28,600
Racinos	<u>6,900</u>	<u>4,600</u>	<u>3,500</u>
Proprietary installed base	37,200	34,000	32,100
Casino owned units	<u>18,000</u>	<u>18,800</u>	<u>19,500</u>
Grand total	<u>55,200</u>	<u>52,800</u>	<u>51,600</u>

Source: Company 10-K.

<sup>7</sup> Company 10-K.

<sup>8</sup> Company 10-K.

<sup>9</sup> Company 2004 Annual Report.

<sup>10</sup> Company 10-K.

## 2. Strong Business Drivers

There are four primary factors affecting demand for IGT products.<sup>11</sup> We view the first two as the most important near-term drivers, and the other two as long-term drivers.

- Replacement of old/obsolete machines due to technological innovation.  
The replacement cycle is a perennially large percentage of sales, and is determined by game manufacturers competing to provide more entertaining and complex games. New machines that achieve higher profitability further accelerate the cycle. Better games and systems are expected to continue to drive replacement demand.
- Casino expansion or addition of casinos in existing markets.  
New casino properties generate demand for new machines. They also generate demand for replacements, as neighboring casinos often respond to the new competition by upgrading gaming machines.
- Creation of new gaming jurisdictions.  
The past decade has seen a large increase in the installed base of gaming machines due to growth in jurisdictions with legalized gaming and heightened visitation to theme-based casinos. IGT aims to sustain a competitive advantage in providing games to new casinos through manufacturing and product innovation.
- Entertainment value to the player.  
IGT considers this “the most important feature of our products,”<sup>12</sup> noting that this in turn ties to price, service, reliability, and reputation of the manufacturer. Better machine design, hardware/software, features, and “ease of play” increase the profitability of machines and IGT customers’ return on investment.

## 3. Savvy Acquisition Activity

IGT has undertaken a number of acquisitions in recent years to increase its geographic reach, expand product lines, build its customer base, and leverage its capabilities in technology and manufacturing.<sup>13</sup>

<u>Company</u>	<u>Date Acquired</u>	<u>Acquisition Cost</u>
<i>(In millions)</i>		
Acres Gaming Inc.	October 2003	\$ 134.0
Anchor Gaming	December 2001	1,323.9
Silicon Gaming, Inc.	March 2001	47.4
Sodak Gaming, Inc.	September 1999	198.9
Barcrest Limited	March 1998	72.9
Olympic Amusement Pty. Limited	March 1998	108.9

Source: Company 10-K. Acquisition cost includes debt assumed.

The company’s most recent acquisition, Acres Gaming, brought a systems software development company into IGT’s systems business. Acres has patented technology that

<sup>11</sup> Company 10-K.

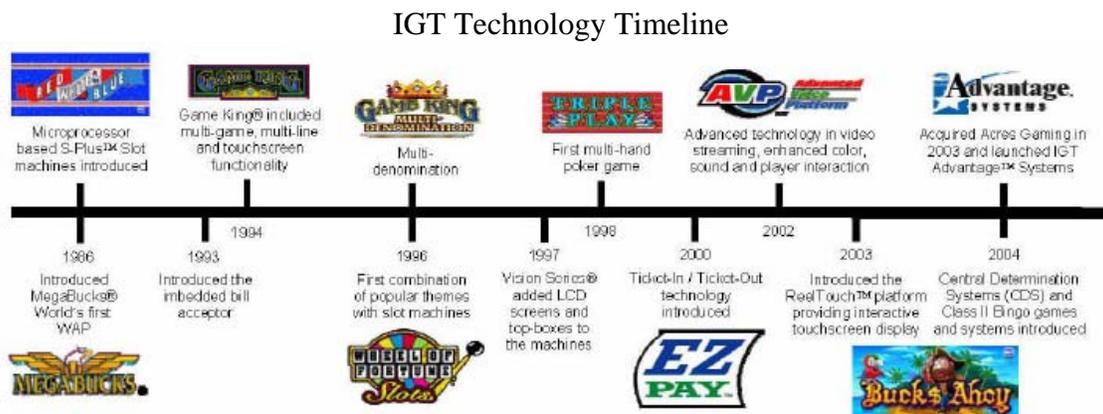
<sup>12</sup> Company 10-K.

<sup>13</sup> Company 10-K.

allows casino operators to enhance patron loyalty. We believe this positions the company well to assume the same industry leadership in gaming systems that it has in gaming machines.

#### 4. Product Innovation Leadership

We believe that IGT's leadership in the global gaming industry ultimately rests on its capabilities in designing and developing games that are "entertaining." The company has a notable emphasis on research and development, with six design centers around the world. R&D investment totaled \$129M in FY2004, versus \$94.9M in FY2003.<sup>14</sup> Below is IGT's product development timeline.



Source: Company 10-K.

#### Games

To maximize "player appeal," IGT combines "art, math, sound, play mechanics, and technological advancements"<sup>15</sup> with an entertainment license library and patented intellectual property. Its continued commitment to game development is seen in the 125 new game themes introduced in FY2004 for the spinning reel, video, and video poker markets in North America. In international markets, IGT works to create a local presence and customized games.

#### Platforms

IGT has developed platforms—PC, video, and other technologies supporting IGT and non-IGT games—and entered new markets such as Alabama and Native American Class II markets. The company has a large market share in government sponsored public gaming and video lottery markets in North America.

#### Systems

The IGT Advantage system, a suite of casino management software products, includes a number of innovations. EZ Pay Ticketing allows slot machines to accept tickets rather than coins. IGT was the first company to introduce ticket-in, ticket-out (TITO) systems, and leads the industry with over 50% of the systems installed in North America.<sup>16</sup>

<sup>14</sup> Company 10-K.

<sup>15</sup> Company 2004 Annual Report.

<sup>16</sup> Company 10-K.

Bonusing Technology enables the delivery of bonuses to players at the point and time of play. Loyalty Game uses club cards and bonus rounds to encourage players to return to a specific property (for multi-session games).

### ***Intellectual Property***

IGT has approximately 700 active domestic and foreign patents in its product portfolio.<sup>17</sup> These patents encompass game design, device components, systems, and aspects of video and electronic slot machines. Most IGT products are sold under trademarks and copyrights to provide product recognition and promote acceptance. Products may also have content licensed from third parties.

### **5. Broad Market Opportunities**

IGT markets products to legalized gaming jurisdictions globally. Its most important markets today, in North America, are maturing. But it is actively pursuing international opportunities, which we see as an important revenue and profit source going forward.

### ***North America***

As discussed in our industry report, the mainstreaming of gaming as a form of entertainment has broadened markets and created new ones. For game manufacturers, important demand growth has taken place in riverboat gambling in the Midwest; Native American casino gaming; and Canadian and non-casino government gaming markets. Recent growth is also appearing in Class II (mainly bingo) markets. The installed base of gaming machines has risen from 184,000 in 1991 to 802,000 in 2004.<sup>18</sup>

<u>September 30,</u>	<u>Estimated Installed Base</u>	
	<u>2004</u>	<u>2003</u>
<i>US</i>		
Nevada	205,000	210,000
Atlantic City	42,000	42,000
Native American <sup>(1)</sup>	224,000	196,000
Regional	165,000	160,000
Racinos and Lottery	<u>83,000</u>	<u>72,000</u>
Total US	<u>719,000</u>	<u>680,000</u>
<i>Canada</i>		
Casinos	44,000	40,000
Racinos and Lottery	<u>39,000</u>	<u>39,000</u>
Total Canada	<u>83,000</u>	<u>79,000</u>
Total North America	<u>802,000</u>	<u>759,000</u>

<sup>(1)</sup> Native American installed base now includes Class II and Class III gaming machines.

Source: Company 10-K.

<sup>17</sup> Company 10-K.

<sup>18</sup> Company 10-K.

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We expect further—though not rapid—expansion in North America. Pennsylvania has passed legislation for gaming machines, creating an installed base potential of 60,000 machines. Two counties in Florida are pursuing gaming machines, and Oklahoma has approved racetracks that would be allowed to install machines. States with budget deficits and legislation related to the legalization of machine gaming include Ohio, Maryland, Massachusetts, and Texas.<sup>19</sup>

### *Nevada*

This is IGT's most competitive market, and has 205,000 machines.<sup>20</sup> Sales have increased due to replacement demand from TITO initiatives by Harrah's Entertainment and Station Casinos Inc. Plans to expand the market—including Wynn Las Vegas in April 2005—will also stimulate machine demand.

### *Atlantic City*

TITO initiatives have also driven demand growth in this market. Expansion plans include the Borgata in FY2006.

### *Native American*

IGT distributes games to Native American casinos through its South Dakota facility. Unlike traditional casino gaming, Native American gaming is regulated by classes:

- ♣ Class I Gaming - Traditional Native American social and ceremonial games; regulated exclusively at the tribal level.
- ♣ Class II Gaming - Bingo, pull-tabs, punch board, tip jars, instant bingo and other games similar to bingo; regulated by individual tribes, with the National Indian Gaming Commission (NIGC) having oversight of the regulatory process.
- ♣ Class III Gaming - All forms of casino-style gaming not included under Class I and Class II, including traditional slot machines and table games; governed by compacts negotiated between individual tribes and states.

Source: Company 10-K.

IGT distributes Class III machines to tribes that have received federal approval. The Class III installed base was 177,000 at the end of FY2004. The company also began distributing Class II machines—an installed base of 47,000 at end FY2004—in the second half of FY2004 and plans to expand in Florida and Oklahoma in FY2005.<sup>21</sup>

### *Regional*

This market includes riverboat gambling in Illinois, Indiana, Iowa, Louisiana, Mississippi, and Missouri, as well as land-based casinos in Detroit and Colorado and sales to cruise ships. The total market is estimated at 165,000 machines.<sup>22</sup> TITO replacement sales have been strong, with potential for growth (new casinos, licenses) in virtually all of these states.

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<sup>19</sup> Company 10-K.

<sup>20</sup> Company 10-K.

<sup>21</sup> Company 10-K.

<sup>22</sup> Company 10-K.

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***Racinos and Lottery***

IGT offers VLTs—video lottery machines with limited bet amounts and payouts controlled by state lotteries—and casino-style gaming machines and systems to government jurisdictions (sale or participation). Driving this market is the addition of 4,000 VLTs at racetracks in New York; 23% of these were IGT machines.<sup>23</sup> Another growth market may be charitable bingo gaming, already in Alabama.

***Canada***

Canada has 60 casinos with 44,000 gaming machines and operating under government controlled lottery corporations. There is also a public gaming market of 39,000 machines in bars and taverns. IGT has a contract with Manitoba Lottery Corporation and is providing machines for a new casino for the Ontario Lottery Corporation. There is no meaningful replacement market.<sup>24</sup>

***International***

To address the globalizing of gaming, IGT has set up international headquarters in the Netherlands to serve markets in Europe, Latin America, Russia, South Africa, Australia, New Zealand, and AWP and low-payout markets in the UK and Japan.<sup>25</sup>

We believe that the AWP and low-payout markets deserve mention for their different (lower) economies, due to local laws and regulations. These markets require more frequent product releases and shorter product life cycles, and achieve lower sales prices and margins. This is an important tradeoff that will be reflected in our valuation.

The international outlook is improving, with strong prospects in the UK, Macau, and Russia. For many of these countries, gaming is seen as a way to increase tourism. We project international markets to account for a growing share of IGT's profits. Below are short descriptions of markets, as described in the company 10-K. We think Japan deserves special attention, as does Australia—though we see competition for the latter.

**Europe**

Management expects moderate installed base growth and plans to open an office in Russia in the near future.<sup>26</sup>

**Latin America**

IGT sells to this region through its Argentine office and expects some growth.

**South Africa**

South Africa has 40 casino licenses to allocate among its nine provinces.<sup>27</sup>

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<sup>23</sup> Company 10-K.

<sup>24</sup> Company 10-K.

<sup>25</sup> Company 10-K.

<sup>26</sup> Company 10-K.

<sup>27</sup> Company 10-K.

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### Australia and New Zealand

These are large markets for video gaming products but face proposed machine limits and gaming tax hikes in some jurisdictions.

### AWP and Low Payout (UK and Japan)

IGT bought Barcrest, an AWP machine manufacturer in the UK, in 1998; this is a replacement-driven market with 250,000 units and new launches every 4-6 weeks. In Japan, the installed base of pachisuro machines is 1.6 million units and machines turn over every 2 years.<sup>28</sup>

## **6. Intensifying Competition**

The gaming machine and system industry is highly competitive, with product development serving as an important source of competition. IGT tries to sustain a competitive advantage through a library of popular games; intellectual property; quality and size of sales force; financial strength; manufacturing capabilities; and pricing strategy. It also competes through infrastructure, brand, product appeal, jackpots, loyalty, technical expertise, and marketing ability.

While competition in the international market is currently less cut-throat due to the growth rate, North American competition has been heating up in the slot machine business. New machines and replacement by different companies have eroded IGT's market share. In order to maintain its competitive edge, IGT will need to continue to invest in R&D. Its success will depend much on their innovation in Class II and III games. IGT's top competition is listed below.

**Alliance Gaming Corp (AGI)** is a global designer, manufacturer, and distributor of gaming machines and computerized gaming monitoring systems. In addition, they design and sell highly specialized accounting and security monitoring systems. They have a slight forward integration into the casino industry in that they own and operate a dockside casino in Mississippi and a small casino in Nevada.<sup>29</sup>

**WMS Industries (WMS)** designs, manufactures and markets gaming machines and video lottery terminals. They have a presence in all major US gaming jurisdictions and 50 international locations. Many machines incorporate themed brands such as Monopoly. WMS generates revenue through the sale of machines and royalties from third party licensing agreements.<sup>30</sup>

**Aristocrat Leisure Limited (Privately held)** is an Australian manufacture of slot machines ranking #2 in worldwide sales. They produce machines for over 60 countries targeting a large range from high-end hotels and casinos to low-end bars. In 2001, Aristocrat acquired Casino Data Systems, which has aided their research and development in the gaming industry.<sup>31</sup>

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<sup>28</sup> Company 10-K.

<sup>29</sup> Yahoo! Finance.

<sup>30</sup> Yahoo! Finance.

<sup>31</sup> Hoover's Online.

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**G-Tech Holdings Corporation (GTK)** designs, sells and operates point-of-sale lottery terminals that are electronically linked between the retailer and the lottery authority, while tracking the funds within the system. It currently has contracts with 27 of the 41 lottery authorities in the US and 57 of 113 internationally.<sup>32</sup>

**Progressive Gaming International Corp (Mikohn Gaming Corp) (PGIC)** develops and markets gaming technology products worldwide. There three core businesses are Slots and Table Games, Product Sales, which includes the design and distribution of progressive slot machines, and Systems, which develops player and accounting tracking systems for slots and table games. Progressive is unique as it offers an integrated package of gaming machines and management systems. The company claims that one of their machines is located in virtually all casinos throughout the world.<sup>33</sup>

Several of these companies have been faster to embrace new technologies, such as penny slots. A number of analysts have expressed concern that Alliance, Aristocrat, and WMS in particular will continue to steal market share from IGT in North America—making international expansion even more important.

### 7. Uncertain Near-term Outlook

IGT has recently experienced several years of record sales growth. This growth can be attributed primarily to the replacement cycle of TITO, accelerated by the conversion from quarter slots to token slots. IGT estimates that some 200,000 machines have yet to be converted, but expects fiscal 2005 to be “a transitional year”<sup>34</sup> as the TITO replacement market in North America matures and machine demand declines.

IGT hope to offset the anticipated decline in machine demand in three ways:

- Higher profit contribution from international markets
- Margin growth through product mix diversification
- Revenue growth from non-machine products.<sup>35</sup>

Nonetheless, IGT is highly dependent on gaming market expansion for growth, and “opportunities have been slower to materialize than previously expected.”<sup>36</sup>

One of the expected “gaming products of the future” is “system-centric SBG” (slot-based gaming). The company is introducing “casino-wide integrated products” that enhance the players’ gaming experience and provide operational efficiencies for customers. IGT is developing SBG applications such as more active casino floor management, “games-on-demand,” player-shared interactive games, and tools to manage customer pricing.<sup>37</sup> As the market shifts toward a more system-centric gaming environment, a growing portion of IGT’s business is anticipated to come from non-box revenues such as these. However, it is unclear how dominant IGT will be in this area.

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<sup>32</sup> Yahoo! Finance.

<sup>33</sup> Company website.

<sup>34</sup> Company 10-K.

<sup>35</sup> Company 10-K.

<sup>36</sup> Company 10-K.

<sup>37</sup> Company 10-K.

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We generally agree with IGT management's expectation of additional fiscal 2005 growth in the installed base of its casino market gaming operations.<sup>38</sup> Part of this growth will come from the introduction of three new video games, including *Fort Knox*®, *Star Wars*®, and *Video Megabucks*®. IGT continues to move into non-traditional gaming markets, and has outstanding orders for over 1,500 gaming operations units.<sup>39</sup> It is also working to improve gaming operations revenues by managing the types of games and the jurisdictions where games are placed.

Traditionally, IGT has performed strongly with both spinning reel and video poker machines. However, it has begun to experience increased competition and challenges to its market share in the North American spinning reel market—challenges that we have incorporated into our valuation.

### 8. Mixed Recent Performance

In its January conference call and 10-Q, IGT reported improved financial results in the first quarter of 2005.<sup>40</sup> These were due to record international revenues and shipments, especially in Japan, where a “pachishuro” game, *The Terminator*™, has been very successful. We believe that IGT must continue to internationalize to offset the slowing of the North American market's replacement demand.

IGT's consolidated gaming operations revenues grew in the first quarter of fiscal 2005. This can be attributed to both an increase in the installed base of machines and improvements in the “game placement mix”—the strategic placement of machines in order to achieve higher yields per game placed. Leaving out the extra week in the prior year quarter and the effect of the VIE consolidations in the current quarter, gaming operations revenues grew by 7% and gross profit by 4%.<sup>41</sup>

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<sup>38</sup> Company 10-K.

<sup>39</sup> Company 10-K.

<sup>40</sup> Company 10-Q.

<sup>41</sup> Company 10-Q.

IGT Product Sales Summary		
Quarters Ended December 31,		
	2004	2003
Revenues (in \$ millions)		
North America	182.1	236.9
International	172.2	93.6
Total	354.3	330.5
Gross Margin		
North America	55%	53%
International	37%	44%
Total	46%	50%
Units Shipped		
North America	14,700	22,600
International	40,600	23,500
Total	55,300	46,100
Average Revenue Per Unit (ARPU)		
North America	12,400	10,500
International	4,200	4,000
Total	6,400	7,200

Source: Company Reports

### ***North America in 1Q 05***

In North America, product sales revenues and gross profit decreased during the current quarter as a result of a reduced demand for TITO related replacement machines, offset by higher pricing. Improvements in product sales gross margin and ARPUs in the current quarter resulted from price increases and lower material costs, greater use of higher margin IGT Advantage™ systems, and added revenues from intellectual property.<sup>42</sup>

North America product sales totaled \$50.2 million in the current quarter and \$49.3 million in the prior year quarter. Margins on non-machine related revenues range slightly (10-30 cents per machine) higher than machine margins. IGT expects North America product sales gross profit margins to run approximately 54% to 56% for the remainder of fiscal 2005 from stronger pricing and additional systems related revenues, game conversions and machine retrofits.<sup>43</sup>

The most recent replacement cycle, coming from demand for cashless enabled gaming machines is clearly slowing. Our valuation incorporates IGT management's expectation that demand will remain below the levels experienced in fiscal 2004, due to this cyclical slowing and the lower-than-expected gaming expansion.

North America gaming operations revenues increased in the current quarter compared to the prior year quarter. This was mainly due to installed base growth, including at racinos and higher play levels on WAP games. Leaving out the extra week of operations which contributed \$19.9 million to the prior year quarter and the additional revenue contributed

<sup>42</sup> Company 10-Q.

<sup>43</sup> Company 10-Q.

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as a result of the VIE consolidations in the current quarter, gaming operations revenues increased by 7%.<sup>44</sup>

North America gaming operations gross profit decreased in the current quarter compared to the prior year quarter. This is attributed to an increase in the current installed base of lower yielding racino and CDS games and expenses related to the managed removal of lower performing games and obsolescence. Partially offsetting these factors were additional contributions from higher yielding WAP units and reduced jackpot expense resulting from favorable interest rates.<sup>45</sup>

IGT's installed base grew compared to the prior year quarter as a result of an additional 1,700 game placements in the racino markets of New York, Delaware, and Rhode Island. It also experienced growth of 900 games in Alabama and the Native American markets of Florida and Oklahoma.<sup>46</sup>

Our valuation considers management's expectation of further growth in its installed base during the remainder of fiscal 2005, through the introduction of several new games and expansion into non-traditional gaming markets such as Alabama, Oklahoma, Florida and Washington. It also takes into account expectations that consolidated gaming operations gross margins will fluctuate between 52-55% for the rest of fiscal 2005.<sup>47</sup>

### ***International in 1Q 05***

First quarter international product sales revenues, gross profit and ARPU increased compared to the prior year quarter. This was mainly due to Japan's shipments of 29,600 units of *The Terminator*<sup>TM</sup> (increasing revenues by \$69.5 million), and to favorable foreign exchange rates. At the same time, gross margin declined—as these are lower margin Japanese pachisuro games (about 32%).<sup>48</sup>

Current growth in international machine shipments is linked to strong replacement shipments in Japan and increased sales in South Africa and the European casino markets. In Japan, *The Terminator*<sup>TM</sup> pachisuro game, the first game to be released under a partnership with Sega Sammy Holdings, Inc. IGT's next game in Japan is scheduled for release in June 2005. Although the Japanese market is cyclical and low-payout, it offers a base of approximately 1.6 million machines, of which over 50% are replaced annually.<sup>49</sup>

Management expects international margins to continue to fluctuate with the geographic mix of games, especially related to Japan's pachisuro machines and their lower sales prices and margins. Continued success in Japan would increase operating income but reduce gross margin percentage.

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<sup>44</sup> Company 10-Q.

<sup>45</sup> Company 10-Q.

<sup>46</sup> Company 10-Q.

<sup>47</sup> Company 10-Q.

<sup>48</sup> Company 10-Q.

<sup>49</sup> Company 10-Q.

## Risks

Although IGT is subject to numerous risks in its business operation and our valuation, we believe that the following risks have the largest potential impact.

**Lack of Innovation.** To stay competitive and maintain revenue growth, IGT will need to continually offer new, innovative games that are embraced by the players. Although IGT plans to invest \$140 million into R&D, almost three times as much as its next largest competitor, this is no guarantee of acceptance of new products.

**Decline in Gambling.** Unfavorable market growth rates, caused by social or economic factors, in both new and existing markets will decrease the demand for new machines. The slow growth would also negatively affect the revenue from gaming operations. In addition, casinos trying to maintain positive cash flows in downtimes may delay the replacement of older machines, which would further hurt IGT.

**Regulatory Hold Up.** Slow regulatory approval for slot machines at the state level will adversely affect the demand for new machines. Approval is slower than expected in states such as New York and Pennsylvania, and further delays will push IGT's expected cash flows further into future years.

**International Growth.** Expansion into international markets makes IGT susceptible to exchange rate risk, new regulations, and additional competition. Maintenance of desired levels of market share may come at the expense of lower profitability.

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## Valuation

### Discounted Cash Flow

Using a DCF analysis for our valuation, we have calculated an estimated target price of \$30.71 per share, a 21% premium to the closing price on Tuesday, April 13, of \$25.10.

Assumptions underlying our valuation, which are based on historic ratios and industry trends, include:

- Initial WACC calculation of 6.61% used a beta from Yahoo! Finance and to that we added a 2% premium for international and regulatory risks to get a WACC of 8.61%. The cost of debt was determined by a premium of 1.5% over a risk free rate, in line with its BBB debt rating. Cost of equity was determined using CAPM. Please see Appendix.
- Growth rates for product sales and gaming operations are probability-weighted.
  - Product sales growth recovers from the replacement cycle slowdown to reach 23% in 2008 before declining to 8% by 2013. Driving this growth is International growth of 40% through 2008, declining to 10% by 2013. We believe these growth rates are justified by strong early indications for 2005, a positive outlook in Japan, and IGT's leading overseas sales and marketing presence.
  - Gaming operations growth remains at 10% through 2008, increases to 11% in 2009 and falls to 6% by 2013. These numbers are based on our expectation of continued healthy revenue-sharing relationships with casino operators in existing and new properties.
- Gross margins from product sales shrink from 52 to 44% beginning in 2005 as a result of the increased competition squeezing prices and the lower margins on the increasing share of international sales.
- SG&A expenses are to be 12.5% of revenue.
- R&D expenses are projected at \$142.2 million in 2005 based on commentary from IGT's CEO and are grown at a rate of 10%.
- Provisions for bad debt are 1.5% of sales.
- Interest income grows conservatively at 5%.
- Interest expense remains unchanged as redemption of debt and refinancing occurred in 2004 and is not anticipated in the future.
- Depreciation and Amortization grow at 15%.



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It is our belief that the industry as a whole is trading at relatively low multiples and that a higher multiple is justified. Based on the historic P/E of IGT, the historic P/E of its most similar competitors, and its growth opportunities, we feel a P/E of 23 is justified. This would imply a valuation of \$31.51/share, which is slightly higher than the DCF valuation.

	Forward P/E	3-year low	3-year high
Alliance Gaming	20.56	10.2	36
WMS Industries	23.07	17	395
IGT	18.32	13	40

Source: Yahoo! Finance.

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## Recommendation

We believe the market has overreacted to the most recent quarterly results of operations from IGT, resulting in an undervaluation. We believe IGT remains a compelling business model with a long history of producing innovative games, a commitment to research and development, and a clear strategy to move aggressively beyond North American slots and into casino systems and international markets. Although market share in North America may have slightly decreased, IGT still remains the dominant slot provider, and we expect systems products and international opportunities to fill the revenue gap. As more US casinos open locations abroad and operate casinos in newly regulated US States, IGT will capitalize on its current relationships and ability to meet order demand and place their slots and systems.

For these reasons, we recommend buying IGT, which is trading at \$25.10- its 52-week low, with a target price of \$30.71/share.

Appendix

CONSOLIDATED STATEMENTS OF INCOME  
(in thousands)

	Historical					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Years ended September 30,												
North American Product sales	614,780	842,898	991,036	891,932	1,025,722	1,128,294	1,241,124	1,365,236	1,488,108	1,607,156	1,719,657	1,822,837
YoY Growth		37%	18%	-10%	15%	10%	10%	10%	9%	8%	7%	6%
International Product sales	231,300	225,700	330,300	462,420	647,380	906,343	1,268,880	1,649,545	1,979,454	2,177,399	2,395,139	2,634,653
YoY Growth		-2%	46%	40%	40%	40%	40%	30%	20%	10%	10%	10%
<b>Total Product sales</b>	<b>846,080</b>	<b>1,068,598</b>	<b>1,321,336</b>	<b>1,354,352</b>	<b>1,673,110</b>	<b>2,034,638</b>	<b>2,510,004</b>	<b>3,014,781</b>	<b>3,467,561</b>	<b>3,784,555</b>	<b>4,114,796</b>	<b>4,457,489</b>
YoY Growth		26%	24%	2%	24%	22%	23%	20%	15%	9%	9%	8%
Cost of product sales	482,490	545,453	631,161	758,437	936,942	1,139,397	1,405,602	1,688,277	1,941,834	2,119,351	2,304,286	2,496,194
Gross Profit from Product Sales	363,590	523,145	690,175	595,915	736,169	895,241	1,104,402	1,326,504	1,525,727	1,665,204	1,810,510	1,961,295
YoY Growth		44%	32%	-14%	24%	22%	23%	20%	15%	9%	9%	8%
North American Gaming Operations	872,132	1,047,239	1,146,016	1,260,618	1,386,679	1,525,347	1,677,882	1,845,670	2,011,781	2,172,723	2,324,814	2,464,302
YoY Growth		20%	9%	10%	10%	10%	10%	10%	9%	8%	7%	6%
International Gaming Operations	10,300	12,300	17,400	22,620	29,406	38,228	49,696	64,605	77,526	85,279	93,806	103,187
YoY Growth		19%	41%	30%	30%	30%	30%	30%	20%	10%	10%	10%
<b>Total Gaming operations</b>	<b>882,432</b>	<b>1,059,539</b>	<b>1,163,416</b>	<b>1,283,238</b>	<b>1,416,085</b>	<b>1,563,575</b>	<b>1,727,578</b>	<b>1,910,275</b>	<b>2,089,307</b>	<b>2,258,002</b>	<b>2,418,620</b>	<b>2,567,489</b>
YoY Growth		20%	10%	10%	10%	10%	10%	11%	9%	8%	7%	6%
Cost of gaming operations	403,129	487,779	534,342	603,122	665,560	734,880	811,962	897,829	981,974	1,061,261	1,136,751	1,206,720
Gross Profit from Gaming Operations	479,303	571,760	629,074	680,116	750,525	828,695	915,616	1,012,446	1,107,332	1,196,741	1,281,869	1,360,769
YoY Growth		19%	10%	8%	10%	10%	10%	11%	9%	8%	7%	6%
Total Gross Profit	842,893	1,094,905	1,319,249	1,276,031	1,486,894	1,723,935	2,020,018	2,338,949	2,633,059	2,861,945	3,092,379	3,322,065
YoY Growth		30%	20%	-3%	17%	16%	17%	16%	13%	9%	8%	7%
Selling, general and administrative	221,673	272,757	293,144	329,699	386,149	449,777	529,698	615,632	694,608	755,320	816,677	878,122
Research and development	77,921	94,932	129,273	142,200	156,420	172,062	189,269	208,195	229,015	251,917	277,108	304,819
YoY Growth		22%	36%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Provision for bad debts	18,032	14,574	18,179	20,315	25,097	30,520	37,650	45,222	52,013	56,768	61,722	66,862
EBITDA	525,267	712,642	878,657	783,817	919,027	1,071,577	1,263,402	1,469,900	1,657,422	1,797,941	1,936,872	2,072,261
YoY Growth		36%	23%	-11%	17%	17%	18%	16%	13%	8%	8%	7%
Depreciation and amortization	41,287	46,700	64,333	70,766	77,843	86,627	94,190	103,609	113,970	125,367	137,903	151,694
YoY Growth		13%	38%	10%	10%	10%	10%	10%	10%	10%	10%	10%
<b>EBIT</b>	<b>483,980</b>	<b>665,942</b>	<b>814,324</b>	<b>713,050</b>	<b>841,184</b>	<b>985,950</b>	<b>1,168,212</b>	<b>1,366,291</b>	<b>1,543,453</b>	<b>1,672,574</b>	<b>1,798,968</b>	<b>1,920,567</b>
YoY Growth		38%	22%	-12%	17%	17%	19%	17%	13%	8%	8%	7%
Interest income	50,423	52,908	59,783	62,772	65,911	69,206	72,667	76,300	80,115	84,121	88,327	92,743
YoY Growth		5%	13%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Interest expense	(116,021)	(116,854)	(90,534)	(59,564)	(59,564)	(59,564)	(59,564)	(59,564)	(59,564)	(59,564)	(59,564)	(59,564)
YoY Growth		1%	-23%	-34%	0%	0%	0%	0%	0%	0%	0%	0%
Loss on redemption of debt	(21,176)	(1,057)	(127,939)	0	0	0	0	0	0	0	0	0
YoY Growth		-95%	12004%	-100%	0%	0%	0%	0%	0%	0%	0%	0%
Other	11,643	(2,395)	(2,218)	(2,329)	(2,445)	(2,568)	(2,696)	(2,831)	(2,972)	(3,121)	(3,277)	(3,441)
YoY Growth		-121%	-7%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Other income (expense), net	(75,131)	(67,398)	(160,908)	879	3,901	7,075	10,407	13,905	17,579	21,436	25,486	29,738
YoY Growth		-10%	139%	-101%	344%	81%	47%	34%	26%	22%	19%	17%
Pre-tax income	408,849	598,544	653,416	713,930	845,086	983,024	1,179,619	1,380,196	1,561,031	1,694,010	1,824,454	1,960,305
Provision for income taxes	154,136	223,257	223,663	242,736	287,329	337,628	401,070	469,267	530,751	575,963	620,314	663,104
Tax Rate	38%	37%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
Income from continuing operations	254,713	375,287	429,753	471,194	557,757	655,396	778,548	910,930	1,030,281	1,118,046	1,204,140	1,287,202
YoY Growth		47%	15%	10%	18%	18%	19%	17%	13%	9%	8%	7%
Discontinued operations, net of tax	16,452	15,440	56,924	471,194	557,757	655,396	778,548	910,930	1,030,281	1,118,046	1,204,140	1,287,202
YoY Growth		44%	25%	-4%	18%	18%	19%	17%	13%	9%	8%	7%
<b>Net income</b>	<b>271,165</b>	<b>390,727</b>	<b>486,677</b>	<b>471,194</b>	<b>557,757</b>	<b>655,396</b>	<b>778,548</b>	<b>910,930</b>	<b>1,030,281</b>	<b>1,118,046</b>	<b>1,204,140</b>	<b>1,287,202</b>
YoY Growth		44%	25%	-4%	18%	18%	19%	17%	13%	9%	8%	7%
EPS		1.37	1.62	1.90	2.26	2.64	2.99	3.24	3.49	3.73		

	Historical					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Working Capital (000s)</b>												
Years ended September 30,												
Working Capital	750,600	1,133,100	949,700									
Change in Working Capital	153,800	382,500	(183,400)	145,067	169,906	197,902	233,067	270,878	305,628	332,341	359,338	386,374
% of Sales	8.9%	18.0%	-7.4%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%

	Historical					Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Cash Flows (000s)</b>												
Years ended September 30,												
EBIT	483,980	665,942	814,324	713,050	841,184	985,950	1,169,212	1,366,291	1,543,453	1,672,574	1,798,968	1,920,567
Taxes on EBIT	182,460	248,396	278,741	242,437	286,003	335,223	397,532	464,539	524,774	568,875	611,649	652,993
Tax rate	38%	37%	34%	34%	34%	34%	34%	34%	34%	34%	34%	34%
NOPAT	301,520	417,546	535,583	470,613	555,182	650,727	771,680	901,752	1,018,679	1,103,899	1,187,319	1,267,574
+Depreciation	41,287	46,700	64,333	70,766	77,843	85,627	94,190	103,609	113,970	125,367	137,903	151,694
-Change in working capital requirements	153,800	382,500	(183,400)	145,067	169,906	197,902	233,067	270,878	305,628	332,341	359,338	386,374
- Capital expenditures (Net)	116,200	128,600	210,900	141,460	155,606	171,167	188,283	207,112	227,823	250,605	275,666	303,232
<b>Free cash flow</b>	<b>72,807</b>	<b>(46,854)</b>	<b>572,416</b>	<b>254,852</b>	<b>307,513</b>	<b>367,286</b>	<b>444,520</b>	<b>527,372</b>	<b>599,198</b>	<b>646,320</b>	<b>690,219</b>	<b>729,662</b>
YoY growth		-164%	-1322%	-55%	21%	19%	21%	19%	14%	8%	7%	6%

**Calculation of WACC**

WACC: 8.61%

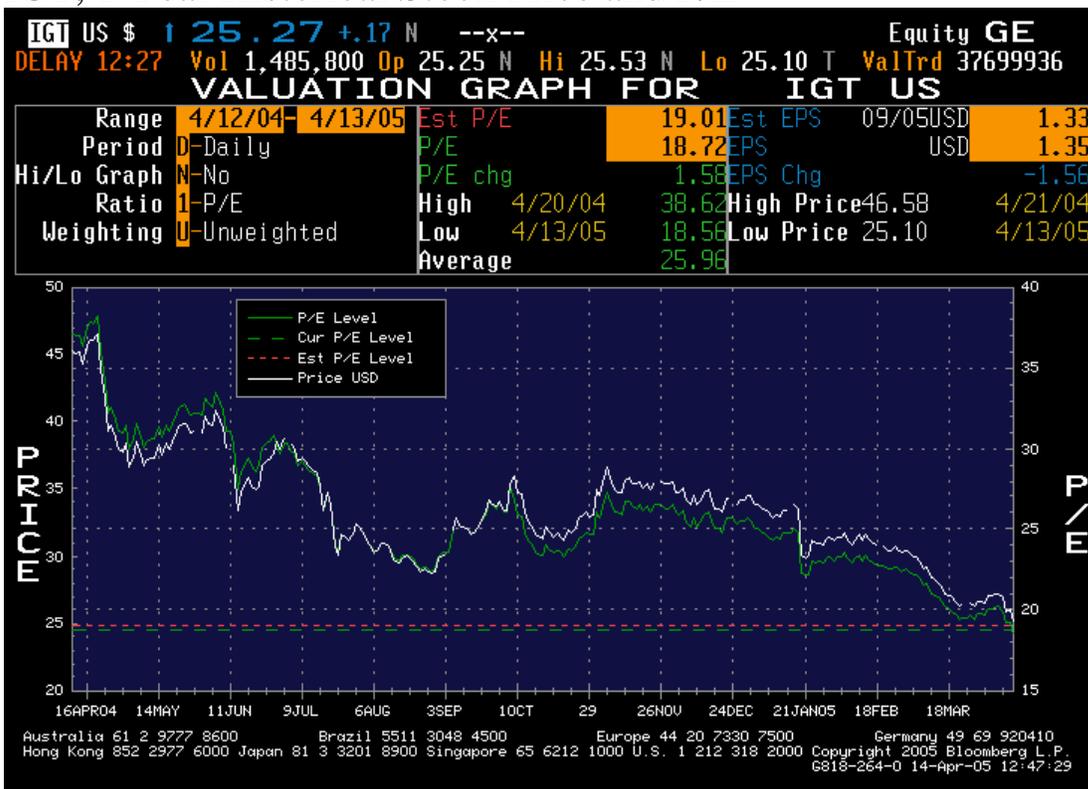
Assumptions	
Debt	D
Equity	E
Debt + Equity	D+E
Debt/Equity	D/E
Debt/Total Capitalization	D/V
Tax Rate	T <sub>c</sub>
Risk Free Rate	r <sub>f</sub>
Market Rate	r <sub>m</sub>
Equity Risk Premium	r <sub>p</sub>
Cost of Debt	r <sub>d</sub>
Cost of Equity	r <sub>e</sub>
beta	β <sub>e</sub>

**Cost of Equity**  
 $r_e = r_f + \beta_e (r_m - r_f)$   
 = 6.83%

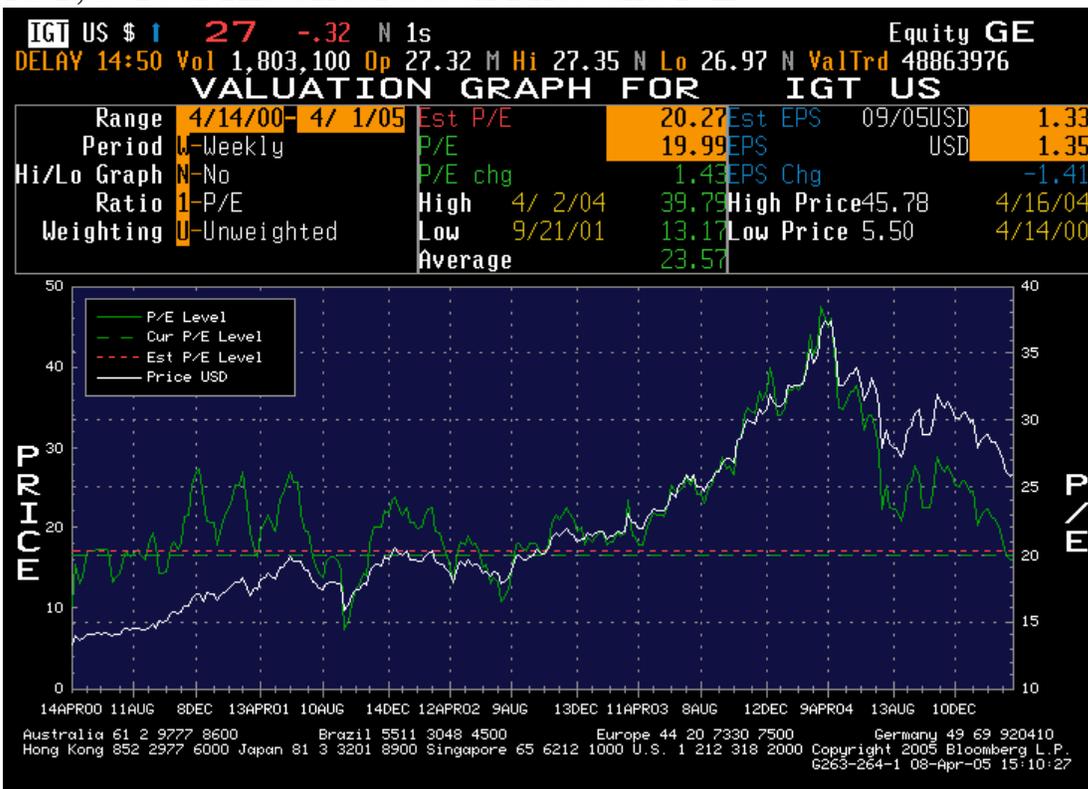
**WACC**  
 $WACC = r_E * E/(E+D) + r_D * (1-T_c) * D/(E+D)$

Initial WACC = 6.61%  
 International and regulatory premium = 2.00%  
 WACC = 8.61%

IGT, 1 Year Historical Stock Price and P/E



IGT, 5 Year Historical Stock Price and P/E



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