

MULTIMEDIA GAMES INC
Form 10-Q
August 16, 2004
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of The Securities Exchange Act of 1934

For the quarterly period ended: June 30, 2004

Transition Report Pursuant to Section 13 or 15 (d) of The Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission File Number: 001-14551

Multimedia Games, Inc.

(Exact Name of Registrant as Specified in its Charter)

Texas
(State or Other Jurisdiction of Incorporation)

74-2611034
(IRS Employer Identification Number)

206 Wild Basin Road, Building B, Fourth Floor

Austin, Texas
(Address of Principal Executive Offices)

78746
(Zip Code)

Registrant's telephone number, including area code: (512) 334-7500

Registrant's website: www.multimedialogames.com

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act.): Yes No

As of August 11, 2004, there were 30,438,031 shares of the registrant's common stock, par value \$0.01 per share, outstanding.

Table of Contents

FORM 10-Q

INDEX

PART I. FINANCIAL INFORMATION

Item 1.	Financial Statements (Unaudited)	
	<u>Consolidated Balance Sheets (As of June 30, 2004 and September 30, 2003)</u>	3
	<u>Consolidated Statements of Income (For the three months ended June 30, 2004 and 2003)</u>	4
	<u>Consolidated Statements of Income (For the nine months ended June 30, 2004 and 2003)</u>	5
	<u>Consolidated Statements of Cash Flows (For the nine months ended June 30, 2004 and 2003)</u>	6
	<u>Notes to Consolidated Financial Statements</u>	8
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	37
Item 4.	<u>Controls and Procedures</u>	37

PART II. OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	39
Item 6.	<u>Exhibits and Reports on Form 8-K</u>	39

Table of Contents

PART I

FINANCIAL INFORMATION

ITEM 2. FINANCIAL STATEMENTS

MULTIMEDIA GAMES, INC.

CONSOLIDATED BALANCE SHEETS

As of June 30, 2004 and September 30, 2003

(In thousands, except shares and per-share amounts)

	June 30, 2004	September 30, 2003
	<u>(Unaudited)</u>	<u></u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 29,648	\$ 26,319
Accounts receivable	9,890	6,387
Allowance for doubtful accounts receivable	(591)	(521)
Inventory, net	4,125	2,446
Prepaid expenses and other	2,783	1,811
Notes receivable, net	1,939	3,659
Federal and state income tax receivable	2,718	1,539
Deferred income taxes	1,827	1,584
	<u>52,339</u>	<u>43,224</u>
Total current assets	52,339	43,224
Restricted cash and long-term investments	1,216	1,380
Inventory, net non-current	23,118	11,742
Property and equipment, net	103,229	78,524
Notes receivable non-current	7,155	500
Other assets	19,105	8,360
	<u>206,162</u>	<u>143,730</u>
Total assets	\$ 206,162	\$ 143,730
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital leases	\$ 9,633	\$ 4,558
Accounts payable and accrued expenses	25,603	20,138
Deferred revenue	244	24
	<u>35,480</u>	<u>24,720</u>
Total current liabilities	35,480	24,720
Long-term debt and capital leases, less current portion	13,114	9,402
Other long-term liabilities	4,206	3,393
Deferred income taxes	7,314	4,103

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Total liabilities	60,114	41,618
Commitments and contingencies (Note 2)		
Stockholders' equity:		
Preferred stock:		
Series A, \$0.01 par value, 1,800,000 shares authorized, no shares issued and outstanding		
Series B, \$0.01 par value, 200,000 shares authorized, no shares issued and outstanding		
Common stock, \$0.01 par value, 75,000,000 shares authorized 30,382,438 and 28,694,028 shares issued, and 28,084,290 and 26,483,622 shares outstanding, respectively	304	287
Additional paid-in capital	64,405	45,487
Stockholders' notes receivable		(1,466)
Treasury stock, 2,298,148 and 2,210,406 shares at cost, respectively	(8,562)	(6,491)
Retained earnings	89,901	64,295
Total stockholders' equity	146,048	102,112
Total liabilities and stockholders' equity	\$ 206,162	\$ 143,730

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Three Months Ended June 30, 2004 and 2003

(In thousands, except per-share amounts)

(Unaudited)

	<u>2004</u>	<u>2003</u>
REVENUES:		
Gaming revenue Class II	\$ 97,692	\$ 82,055
Gaming revenue All other	24,267	1,068
Player terminal and license sale and lease revenue	805	12,489
Other	740	384
	<u> </u>	<u> </u>
Total revenues	123,504	95,996
Allotments to facility operators	86,584	58,004
Bingo prizes and related costs		68
	<u> </u>	<u> </u>
Net revenues	36,920	37,924
	<u> </u>	<u> </u>
OPERATING COSTS AND EXPENSES:		
Cost of player terminals and licenses sold	967	7,335
Selling, general and administrative expenses	12,951	10,599
Amortization and depreciation	9,464	5,512
	<u> </u>	<u> </u>
Total operating costs and expenses	23,382	23,446
	<u> </u>	<u> </u>
Operating income	13,538	14,478
OTHER INCOME (EXPENSE):		
Interest income	178	71
Interest expense	(429)	(187)
	<u> </u>	<u> </u>
Income before income taxes	13,287	14,362
Income tax expense	3,451	5,498
	<u> </u>	<u> </u>
Net income	\$ 9,836	\$ 8,864
	<u> </u>	<u> </u>
Basic earnings per share	\$ 0.35	\$ 0.34
	<u> </u>	<u> </u>
Diluted earnings per share	\$ 0.32	\$ 0.30
	<u> </u>	<u> </u>

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Nine months Ended June 30, 2004 and 2003

(In thousands, except per-share amounts)

(Unaudited)

	<u>2004</u>	<u>2003</u>
REVENUES:		
Gaming revenue Class II	\$ 302,843	\$ 249,709
Gaming revenue All other	44,094	3,132
Player terminal and license sale and lease revenue	7,193	15,623
Other	1,583	1,110
	<u>355,713</u>	<u>269,574</u>
Total revenues	355,713	269,574
Allotments to facility operators	244,738	175,645
Bingo prizes and related costs		1,171
	<u>110,975</u>	<u>92,758</u>
Net revenues	110,975	92,758
OPERATING COSTS AND EXPENSES:		
Cost of player terminals and licenses sold	5,066	8,730
Selling, general and administrative expenses	41,795	29,667
Amortization and depreciation	25,344	15,073
	<u>72,205</u>	<u>53,470</u>
Total operating costs and expenses	72,205	53,470
	<u>38,770</u>	<u>39,288</u>
Operating income	38,770	39,288
OTHER INCOME (EXPENSE):		
Interest income	906	263
Interest expense	(1,067)	(245)
	<u>38,609</u>	<u>39,306</u>
Income before income taxes	38,609	39,306
Income tax expense	13,003	15,049
	<u>25,606</u>	<u>24,257</u>
Net income	\$ 25,606	\$ 24,257
	<u>\$ 0.94</u>	<u>\$ 0.94</u>
Basic earnings per share	\$ 0.94	\$ 0.94
	<u>\$ 0.83</u>	<u>\$ 0.83</u>
Diluted earnings per share	\$ 0.83	\$ 0.83

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

MULTIMEDIA GAMES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine months Ended June 30, 2004 and 2003

Increase (Decrease) in Cash and Cash Equivalents

(In thousands)

(Unaudited)

	<u>2004</u>	<u>2003</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 25,606	\$ 24,257
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Amortization and depreciation	25,344	15,073
Accretion of contract rights	36	
Accrued interest on notes receivable	(682)	
Deferred income taxes	2,968	1,192
Loss on disposal of equipment		51
Options issued to consultants	383	184
Provision for obsolete inventory	826	672
Recovery of doubtful accounts	(17)	
(Increase) decrease in:		
Accounts receivable	(3,583)	(509)
Inventory	(25,525)	(9,472)
Prepaid expenses and other assets	(8,978)	(46)
Federal and state income tax receivable	(1,179)	(2,431)
Other long-term liabilities	977	
Notes receivable - current	1,410	(4,614)
Accounts payable and accrued expenses	5,632	360
Deferred revenue	220	(1,905)
	<u>23,438</u>	<u>22,812</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES		
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment and patents	(31,467)	(20,992)
Restricted cash and long-term investments and other long-term liabilities	(37)	173
Advances under development agreements	(10,182)	(4,765)
Repayments under development agreements	760	
Advances on notes receivable	(20,574)	(500)
Repayments of notes receivable	21,107	
Stockholders' notes receivable, net		322
	<u>(40,393)</u>	<u>(25,762)</u>
NET CASH USED IN INVESTING ACTIVITIES		
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options, warrants, and related tax benefit	18,080	2,914
Principal payments of long-term debt and capital leases	(5,504)	(561)

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Proceeds from long-term debt	7,708	4,371
	<u> </u>	<u> </u>
NET CASH PROVIDED BY FINANCING ACTIVITIES	20,284	6,724
	<u> </u>	<u> </u>
Net increase in cash and cash equivalents	3,329	3,774
Cash and cash equivalents, beginning of period	26,319	15,247
	<u> </u>	<u> </u>
Cash and cash equivalents, end of period	<u>\$ 29,648</u>	<u>\$ 19,021</u>

Table of Contents**MULTIMEDIA GAMES, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)****For the Nine months Ended June 30, 2004 and 2003**

(In thousands)

(Unaudited)

	<u>2004</u>	<u>2003</u>
SUPPLEMENTAL CASH FLOW DATA:		
Interest paid	\$ 1,066	\$ 245
Income tax paid	\$ 418	\$ 14,785
NON-CASH TRANSACTIONS:		
Transfer of inventory to property and equipment	\$ 11,644	\$ 10,382
Property and equipment and other assets acquired through:		
Capital lease	5,280	3,074
Long-term debt	1,303	1,660
Receipt of Company's common stock for repayment of stockholders' note receivable	1,599	644
Receipt of Company's common stock as consideration for employee stock option exercise	472	
Non-compete agreement included in other assets and other long-term liabilities		2,047

The accompanying notes are an integral part of the consolidated financial statements.

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements should be read in conjunction with the Company's consolidated financial statements and footnotes contained within the Company's Annual Report on Form 10-K for the year ended September 30, 2003.

The financial statements included herein as of June 30, 2004, and for each of the three and nine months ended June 30, 2004 and 2003 have been prepared by the Company without an audit, pursuant to accounting principles generally accepted in the U.S. and the rules and regulations of the Securities and Exchange Commission. They do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. The information presented reflects all adjustments consisting solely of normal adjustments which are, in the opinion of management, considered necessary to present fairly the financial position, results of operations, and cash flows for the periods. Operating results for the three and nine months ended June 30, 2004 are not necessarily indicative of the results which will be realized for the year ending September 30, 2004.

Operations. The Company is a technology supplier to the gaming industry. The Company designs and develops interactive, electronic gaming systems that are marketed primarily to Native American, charity and commercial bingo gaming facilities, and to state lottery commissions located throughout the U.S. The Company's gaming systems are typically provided to customers under revenue sharing arrangements, except for video lottery terminals in the Class III market in Washington State, which are typically sold for an up-front purchase price. The Company provides Class II gaming to its tribal customers through a nationwide, broadband telecommunications network. Player terminals in the Class II gaming market are typically interconnected within a gaming facility and across multiple facilities, thereby enabling players to simultaneously participate in the same game and to compete against one another to win common pooled prizes. In the charity bingo market, player terminals are typically only interconnected within the gaming facility where the player terminals are located. The Company provides a central determinant system for use by state lottery commissions. The Company places Point-of-Sale terminals, or POSTs, in conjunction with its Tribal Instant Lottery Game, or TILG, in the Class III market, which is supported by central determinant system technology similar to that used in the state lottery market. The Company offers content for its gaming systems that has been designed and developed by the Company, as well as game themes it has licensed from others.

Consolidation Principles. The Company's financial statements include the activities of Multimedia Games, Inc. and its wholly-owned subsidiaries: MegaBingo, Inc., MGAM Systems, Inc., MGAM Services, LLC, TV Games, Inc. (dissolved April 10, 2003), and Multimedia Creative Services, Inc. (dissolved October 4, 2002). Intercompany balances and transactions have been eliminated.

Accounting Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Examples include provisions for bad debts and inventory obsolescence, asset lives of equipment, deferred taxes, and the provision for and disclosure of litigation and loss contingencies. Actual results may differ from these estimates in the near and long term.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Revenue Recognition. The Company derives its gaming revenues primarily from participation arrangements with its Native American customers and charity bingo customers. Participation revenue generated from the Company's Class II customers is reported in its results of operations as Gaming revenue - Class II, while revenue from charity customers and the Company's TILG product are included in Gaming revenue - All other. Under these arrangements, the Company retains ownership of the player terminals, POSTs and back-office equipment, which are collectively referred to as gaming systems, installed at customer gaming facilities, and receives revenue based on a percentage of the hold per day generated by each gaming system. The network-wide hold of all of these gaming systems is reported by the Company as gaming revenue, and represents the total amount end users wager, less the total amount paid to end users for prizes. The amounts retained by the tribal and charity gaming facilities for their share of the hold are reported by the Company in its results of operations as a part of Allotments to facility operators, and are deducted from the Company's total revenues to arrive at its net revenues.

The Company generates gaming revenues from the state video lottery market by providing the central determinant system for video lottery terminal networks. In return for providing the system, the Company receives a small portion

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

of the network-wide hold, which is reported in its financial results of operations as a part of Gaming revenue All other.

The Company also generates gaming revenues from back-office fees based on a share of the hold per day from both leased and sold Class III video lottery terminals, or VLTs, in Washington State. Back-office fees cover the service and maintenance costs for back-office servers installed in each gaming facility to run its Class III games, as well as the cost of related software updates. These back-office fees are reported in its results of operations as a part of Gaming revenue All other. For those VLTs sold to its customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share received from terminals being rented under participation agreements. Accordingly, the Company derives its Class III revenues to a greater extent from VLT sales than from participation-based back-office fees. Sales of Class III VLTs are usually clustered around the expansion of existing casinos, the opening of new casinos or changes in applicable law that permit customers to operate a greater number of VLTs than previously allowed.

The majority of the Company's Class III VLTs in Washington State have been sold to customers outright for a one-time purchase price, and are reported by the Company under Player terminal and license sale and lease revenue. Certain game themes used by the Company in the Class III market have been licensed from third parties and are generally resold to customers along with the Class III VLTs. Revenues from the sale of Class III VLTs and the sale of player terminal licenses are recognized provided the four basic revenue criteria have been met: a) persuasive evidence of an arrangement exists; b) delivery has occurred and services have been rendered; c) the seller's price is fixed or determinable; and d) collectibility is reasonably assured. For the remainder of its Class III VLTs, the Company enters into either participation arrangements or lease-purchase arrangements. Under lease-purchase arrangements, the Company receives a series of lease payments based on a percentage of the hold per day generated by the VLT. At the end of the lease period, the Company transfers VLT ownership to the customer.

Cash and Cash Equivalents. The Company considers all highly liquid investments (i.e., investments which, when purchased, have original maturities of three months or less) to be cash equivalents.

Allowance for Doubtful Accounts. The Company maintains an allowance for doubtful accounts related to its accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. Management reviews its accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. Management analyzes historical collection trends and changes in its customer payment patterns, customer concentration, and creditworthiness when evaluating the adequacy of its allowance for doubtful accounts. In its overall allowance for doubtful accounts, the Company includes any receivable balances that are determined to be uncollectible. Based on the information available, management believes the allowance for doubtful accounts is adequate; however, actual write-offs might exceed the recorded allowance.

Inventory Current. The Company's current inventory consists primarily of completed Class III VLTs, related component parts and back-office computer equipment for Class III VLTs, as well as completed player terminals expected to be sold within the Company's next fiscal year.

Inventory Non-Current. The Company's non-current inventory consists of completed player terminals and POSTs and related back-office computer equipment expected to be placed with customers under participation arrangements under which the Company retains title to the

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

gaming systems. Such systems are transferred from inventory to the Company's property and equipment upon consummation of such agreements, and as such systems are placed with customers. Non-current inventory also consists of both new and used components, stated at net realizable value.

Inventory Reserves. Inventories are stated at the lower of cost (first in, first out) or market. Management regularly reviews its inventory quantities on hand and records reserves for excess and obsolete inventory, based primarily on its estimated forecast of production and service requirements and product demand.

Development Agreements. The Company enters into development agreements to provide financing for new tribal gaming facilities, or for the expansion of existing facilities. In return, the facility dedicates a percentage of its floor space to exclusive placement of the Company's player terminals, and the Company receives a fixed percentage of those player terminals' hold per day over the term of the agreement. Certain of the agreements contain performance

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

standards for its player terminals that could allow the facility to reduce a portion of the Company's guaranteed floor space. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. Amounts advanced in excess of those reimbursed by the customer for real property and land improvements are allocated to an other asset and amortized over the life of the contract. Amounts related to personal property owned by the Company and located at the tribal gaming facility are carried in the Company's property and equipment and depreciated over the estimated useful life of the related asset. For further discussion regarding the Company's development agreements, see Part 1 Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Risk Factors.

At June 30, 2004, and September 30, 2003, the following amounts related to development agreements were recorded in the following balance sheet captions:

	June 30, 2004	September 30, 2003
	<u>2004</u>	<u>2003</u>
	(In thousands)	
Included in:		
Notes receivable	\$ 6,995	\$ 638
Property and equipment	14,827	4,918
Other assets	5,611	994

Notes Receivable. At June 30, 2004 and September 30, 2003, the Company's notes receivable consisted of the following:

	June 30, 2004	September 30, 2003
	<u>2004</u>	<u>2003</u>
	(In thousands)	
Notes receivable from development agreements	\$ 6,995	\$ 638
Notes receivable from equipment sales	2,120	3,636
Allowance for notes receivable	(21)	(115)
	<u>9,094</u>	<u>4,159</u>
Notes receivable, net	9,094	4,159
Less current portion	1,939	3,659
	<u>7,155</u>	<u>500</u>
Notes receivable - non-current	\$ 7,155	\$ 500

Notes receivable from development agreements are generated from reimbursable amounts advanced under development agreements.

Notes receivable from equipment sales consist of financial instruments issued by customers for the purchase of player terminals and licenses, and generally bear interest at prevailing interest rates. All of the Company's notes receivable from equipment sales are collateralized by the related equipment sold, although the value of such equipment, if repossessed, may be less than the note receivable outstanding.

Property and Equipment. Property and equipment is stated at cost. The cost of property and equipment is depreciated over their estimated useful lives, generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. Substantially all of the Company's property and equipment is depreciated over two to seven years. Player terminals placed with customers under lease arrangements where player terminal ownership is conveyed to the customer at the end of the lease term are depreciated over the shorter of the lease term or three years. Property and equipment includes a pool of rental terminals, i.e., the rental pool. Rental pool units are those units which have previously been in the field, but are currently back at the Company being refurbished and/or awaiting redeployment. Routine maintenance of property and equipment is expensed in the period incurred, while major component upgrades are capitalized and depreciated over the estimated useful life of the component. Sales and retirements of depreciable property and equipment are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in the Company's results of operations.

Internally developed gaming software is stated at cost, which is amortized over the estimated useful life of the software, generally using the straight-line method. The Company amortizes internally developed games and gaming engines over an eighteen-month period, gaming systems over a three-year period, and its central management systems over a five-year period. Software development costs are capitalized once technological feasibility has been established, and are amortized when the software is placed into service. Any subsequent software maintenance costs,

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

such as bug fixes and subsequent testing, are expensed as incurred. Discontinued software development costs are expensed when the determination to discontinue is made.

Management reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to its fair value, which considers the future undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs of disposal. An analysis of the long-lived assets at June 30, 2004 indicated there was no impairment to these assets' carrying values.

Leased Property and Equipment. Property and equipment under capital leases are recorded at the lower of the present value of the minimum lease payments or the fair value of the assets. The cost of leased property and equipment is amortized using the Company's normal depreciation policy, described under Property and Equipment.

Credit Facility, Long-term Debt and Capital Leases. At June 30, 2004 and September 30, 2003, the Company's Credit Facility, long-term debt and capital leases consisted of the following:

	June 30,	September 30,
	2004	2003
	<u> </u>	<u> </u>
	(In thousands)	
Term loan facility	\$ 8,160	\$ 2,361
Other long-term debt	5,375	5,496
Capital lease obligations	9,212	6,103
	<u> </u>	<u> </u>
Long-term debt and capital leases	22,747	13,960
Less current portion	9,633	4,558
	<u> </u>	<u> </u>
Long-term debt and capital leases, less current portion	\$ 13,114	\$ 9,402
	<u> </u>	<u> </u>

The Company's debt structure consists of a Credit Facility, which provides the Company with a \$20.0 million term loan facility, or Term Loan, and a \$5.0 million revolving credit line, or the Revolver. The Term Loan can be drawn under three tranches, based upon the Company's unfinanced capital expenditures, beginning in June 2003 and closing six months apart. The Term Loan matures in June 2006, and bears interest at a rate of Prime plus 1.25%, with a floor of 5.5%, (or 5.75% as of June 30, 2004.) As of June 30, 2004, the Company had drawn \$10.2 million under the first two tranches of the Term Loan. Equal installments of principal and interest are payable over the term of each tranche, which are 36, 30 and 24 months, respectively.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

The Revolver provides the Company with up to \$5.0 million for working capital needs, which is limited by a borrowing base comprised of certain of the Company's accounts receivable and inventory. The Revolver bears interest at a rate of Prime plus 1.25% and has a commitment fee based on the daily average of the unborrowed commitment. The Revolver matures in June 2005. As of June 30, 2004, the borrowing base provided for \$5.0 million in availability, which was reduced to \$4.0 million to reflect outstanding letters of credit; however, there were no outstanding borrowings under the Revolver.

The Credit Facility contains certain customary financial and operational covenants, and is secured by substantially all the Company's assets. The Company was in compliance with these covenants as of June 30, 2004.

Other long-term debt at June 30, 2004 consists of a five-year loan related to financing our corporate aircraft and various three to five-year loans for the purchase of automobiles and property and equipment.

Capital lease obligations consist of various three-year noncancelable capital leases for certain equipment used in the Company's operations.

Fair Value of Financial Instruments. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation. At June 30, 2004 and September 30, 2003, the carrying amounts for the Company's financial instruments, which

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

include accounts and notes receivable, accounts payable, and long-term debt and capital leases, approximate fair value.

Income Taxes. The Company applies the provisions of Statement of Financial Accounting Standards, or SFAS, No. 109 Accounting for Income Taxes. Under SFAS No. 109, deferred tax liabilities or assets arise from differences between the tax bases of liabilities or assets and their bases for financial reporting, and are subject to tests of recoverability in the case of deferred tax assets. The amount of deferred tax liabilities or assets is calculated by applying the provisions of enacted tax laws to determine the amount of taxes payable or refundable currently or in future years. A valuation allowance is provided for deferred tax assets to the extent realization is not judged to be more likely than not.

Treasury Stock. The Company utilizes the cost method for accounting for its treasury stock acquisitions and dispositions.

Stock Split. On February 2, 2004, the Board of Directors declared a two-for-one split of the Company's common stock, to be paid in the form of a stock dividend to stockholders of record as of February 16, 2004. All references in the accompanying financial statements to the number of common shares and per-share amounts have been restated to reflect the split.

Earnings per Common Share. Earnings per common share is computed in accordance with SFAS No. 128, Earnings per Share. Presented below is a reconciliation of net income available to common stockholders and the differences between weighted average common shares outstanding, which are used in computing basic earnings per share, and weighted average common and potential shares outstanding, which are used in computing diluted earnings per share.

	Three Months Ended June 30,	
	2004	2003
	(In thousands, except shares and per-share amounts)	
Income available to common stockholders - basic and diluted	\$ 9,836	\$ 8,864
Weighted average common shares outstanding	27,872,523	25,998,838
Effect of dilutive securities:		
Options	3,063,153	3,541,792
Warrants		94,806
Weighted average common and potential shares outstanding	30,935,676	29,635,436
Basic earnings per share	\$ 0.35	\$ 0.34

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

	\$ 0.32	\$ 0.30
Diluted earnings per share		
Nine months Ended June 30,		
	2004	2003
(In thousands, except shares and per-share amounts)		
Income available to common stockholders basic and diluted	\$ 25,606	\$ 24,257
Weighted average common shares outstanding	27,286,216	25,882,560
Effect of dilutive securities:		
Options	3,465,999	3,292,634
Warrants		119,972
Weighted average common and potential shares outstanding	30,752,215	29,295,166
Basic earnings per share	\$ 0.94	\$ 0.94
Diluted earnings per share	\$ 0.83	\$ 0.83

At June 30, 2003, options to purchase 225,000 shares of Common Stock at exercise prices ranging from \$11.79 to \$15.47 per share were outstanding, but were not included in the computation of diluted earnings per share due to their antidilutive effect. No options were excluded from the computation of diluted earnings per share at June 30, 2004.

Stock-Based Compensation. The Company applies Accounting Principles Board Opinion No. 25, or APB 25, Accounting for Stock Issued to Employees, in accounting for its stock option plans, rather than the alternative fair

Table of Contents**MULTIMEDIA GAMES, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

value accounting provided under SFAS No. 123, Accounting for Stock-Based Compensation. Under APB 25, no compensation expense is recognized for grants of options to common law employees and directors at an exercise price equal to or greater than the market price of the stock on the date of grant. Accordingly, based on the Company's grants in the three and nine months ended June 30, 2004 and 2003, no compensation expense has been recognized.

Pro forma information regarding net income and earnings per share under the alternative fair value accounting is required by SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. For purposes of pro forma disclosures, the estimated fair value of the options granted is amortized to expense over the options' vesting period. Had the Company determined compensation expense for stock option grants based on their estimated fair value on their grant date, the Company's net income and earnings per share would have been as follows:

	Three Months Ended		Nine months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
(In thousands, except per-share amounts)				
Net income:				
As reported	\$ 9,836	\$ 8,864	\$ 25,606	\$ 24,257
Deduct: Estimated stock-based employee compensation determined under fair value method for all awards, net of related tax benefit	(815)	(824)	(3,993)	(3,473)
Pro forma	\$ 9,021	\$ 8,040	\$ 21,613	\$ 20,784
Basic earnings per share:				
As reported	\$ 0.35	\$ 0.34	\$ 0.94	\$ 0.94
Pro forma	\$ 0.32	\$ 0.31	\$ 0.79	\$ 0.80
Diluted earnings per share:				
As reported	\$ 0.32	\$ 0.30	\$ 0.83	\$ 0.83
Pro forma	\$ 0.29	\$ 0.27	\$ 0.70	\$ 0.71

2. COMMITMENTS AND CONTINGENCIES*Litigation*

General. The Company is subject to federal, state and Native American laws and regulations that affect both its general commercial relationships with its Native American tribal customers as well as the products and services provided to them. The following is only a summary of the more material aspects of these laws and regulations, and is not a complete recitation of all applicable law.

Indian Gaming Regulatory Act. Most of the Company's business relates to gaming activities on Native American lands. The operation of gaming on Native American lands is subject to the Indian Gaming Regulatory Act of 1988, or IGRA, which created the National Indian Gaming Commission, or NIGC, to promulgate regulations to enforce certain aspects of IGRA.

IGRA classifies games that may be played on Native American land into three categories: Class I gaming includes traditional Native American social and ceremonial games, and is regulated only by the tribes. Class II gaming includes bingo and, if played at the same location where bingo is played, pull-tabs, lotto, punch boards, tip jars, instant bingo, certain card games played under limited circumstances, and other games similar to bingo. Class III gaming consists of all forms of gaming that are not Class I or Class II, such as video lottery games, slot machines, most table games and keno.

IGRA allows Native American tribes to legally engage in Class II gaming on Native American lands in any state where the state permits such gaming by any person for any purpose. For example, if a state permits churches to hold charity bingo nights, then IGRA would allow tribes to engage in bingo on Native American lands located in that state as a Class II gaming activity, free of any interference, regulation or taxation by that state.

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

IGRA also regulates the terms of gaming management contracts with Native Americans, which must be approved by the NIGC before taking effect. Generally, the NIGC has determined that the agreements pursuant to which the Company provides its Class II games, equipment and services are service agreements and not management contracts, thereby allowing the Company to obtain terms that might otherwise not be permitted. Under existing regulations, management contracts can have a maximum term of seven years, and limit the amount payable to the manager to 30% of the net revenue from the related gaming activity. On occasion, however, as a condition of its approval of a management contract, the NIGC has required that managers accept both a shorter term and a reduced percentage of the net revenue.

On April 23, 2004 the Company reported that the acting General Counsel of the NIGC had issued a letter to the Company and one of its tribal customers opining that the Company's development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. The Company has expressed its disagreement with the acting General Counsel's interpretation, and its belief that her view of management is broader than was intended by Congress. The Company also believes that the acting General Counsel's opinion may be based in part on collateral agreements that it provided to the NIGC in error and that are not presently in effect. The Company, along with certain tribal customers, has submitted additional information and documents related to the development agreements for review by the NIGC. If certain of the Company's development agreements are finally determined to be management contracts, there could be material adverse consequences to the Company. In that event, the Company may be required to modify the terms of such agreements. Such modification may adversely affect the terms on which the Company conducts business and significantly impact its financial condition and results of operations from such agreement and from other development agreements that may be similarly interpreted by the NIGC.

The Company's contracts could be subject to further review at any time. Any further review of these agreements by the NIGC, or alternative interpretations of applicable laws and regulations could require substantial modifications to those agreements or result in their redesignation as management contracts, which could materially and adversely affect the terms on which the Company conducts business.

Johnson Act. The Johnson Act broadly defines an illegal gambling device as any machine or mechanical device designed and manufactured primarily for use in connection with gambling and that, when operated, delivers money or other property to a player as the result of the application of an element of chance. Courts that have considered the scope of the Johnson Act in relation to IGRA have generally determined that the Johnson Act does not prohibit the use of electronic and technological aids to bingo that operate to broaden the participation of players to play against one another rather than against a machine.

Class II gaming is defined by IGRA as including the game of chance commonly known as bingo (whether or not electronic, computer or other technological aids are used in connection therewith.) However, IGRA's definition of Class II gaming expressly excludes electronic or electromechanical facsimiles of any game of chance or slot machines of any kind. Prior to June 17, 2002, regulations adopted by the NIGC defined electronic or electromechanical facsimiles of any game of chance or slot machines of any kind as being equivalent to gambling devices, as defined and prohibited by the Johnson Act.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

On June 17, 2002, the NIGC published new regulations, effective July 16, 2002, defining the terms "electronic, computer or other technological aids" that can legally be used in Class II gaming, and "electronic or electromechanical facsimiles of a game of chance" that may not be legally used in Class II gaming. The NIGC essentially did away with using the Johnson Act definition of "gambling device" as the method of determining what constituted an illegal "electronic or electromechanical facsimile of a game of chance," and relied instead upon existing court cases which have held that legal technological aids permitted by IGRA are aids that broaden the participation levels of players in the same game, facilitate communication between and among gaming facilities, and allow players to play a game with or against other players rather than with or against a machine. Under these court decisions, any devices that accomplish these objectives are not "gambling devices" prohibited by the Johnson Act.

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

These new NIGC regulations are not binding upon the DOJ, the federal agency charged with enforcing the Johnson Act. The DOJ has asserted in the past and, as described below, may continue to assert their position that any electronic or mechanical devices used in gaming, such as the electronic player terminals used to play the Company's Class II games, are illegal gambling devices, and thus in violation of the Johnson Act.

In a decision of the United States Court of Appeals for the Tenth Circuit (*Seneca-Cayuga Tribe of Oklahoma, et al. vs. National Indian Gaming Commission, et al.*, decided April 17, 2003), a federal circuit court considered the Johnson Act's applicability to Class II gaming. The opinion of the court was in line with several previous court opinions (including the Ninth and Tenth Circuit opinions on the Company's MegaMania games) that found that the Johnson Act did not prohibit the use of technological aids to Class II gaming on Native American land. The court also noted that its opinion was in line with the new NIGC regulations. In another decision from the United States Court of Appeals for the Eighth Circuit (*United States of America vs. Santee Sioux Tribe of Nebraska*, decided March 20, 2003), a circuit court found for the first time that the Johnson Act does apply to Class II technological aids, although the court also found that the pull-tab player terminals at issue in that case were not Johnson Act devices. That court also went on to cite the fact that the NIGC has adopted new regulations which would permit Class II technological aids under IGRA.

On November 21, 2003, the DOJ filed a Petition for a Writ of Certiorari in the Supreme Court seeking review of the two U.S. Circuit Court cases that examined whether the Johnson Act prohibits Native American tribes from offering certain types of electronic gaming devices. Specifically, the DOJ sought review of *United States of America v. Santee Sioux Tribe of Nebraska, a Federally Recognized Indian Tribe*, on Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit, and *John D. Ashcroft, Attorney General, et al., v. Seneca-Cayuga Tribe of Oklahoma, et al.* on Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit. In the petitions, the DOJ asserted that the Johnson Act prohibits Native American tribes from operating certain electronic gambling devices without a compact with the appropriate state.

On February 27, 2004, the Supreme Court declined to grant the DOJ's Petitions for Writs of Certiorari. Although the Company's machines were not the subject of the lawsuits, the DOJ's arguments and reasoning appeared to encompass the machines offered by the Company for the Class II market. Since the Supreme Court declined to accept these cases for review, the lower courts' decisions affirming the right of the tribes to offer games such as those manufactured and sold by the Company as legal electronic aids to bingo for the Class II market will continue to stand. The Company believes that for the immediate future, significant legal uncertainty has been eliminated concerning the Company's ability to continue to offer Class II games played with the assistance of technological aids in its principal market. However, the elimination of this legal uncertainty could also result in increased competition from vendors currently in the Class III market who the Company believes have avoided entry into the Class II market due to the legal uncertainties described above.

Tribal-State Compacts.

Oklahoma. In February 2004, legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities in the state, or the Bill, was approved in Oklahoma. The Bill was originally scheduled to become effective 90 days after the end of the current legislative session, which expired at the end of May 2004. However, in May 2004, the Bill was repealed by the Oklahoma Legislature, and substitute legislation was passed by both the Oklahoma Senate and House that requires a statewide referendum in November 2004. Certain groups opposed to the legislation have vowed both to fight the new bills and to attempt to delay the enactment of the new legislation. As a result,

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

the Company is unable to determine when or if any new legislation authorizing certain forms of gaming at the Oklahoma racetracks and additional types of games at tribal gaming facilities will become effective.

The majority of the Company's revenue is generated from the placement of Class II gaming systems with tribal customers who are not parties to any state compact that would permit them to offer Class III games. See Part 1 Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Risk Factors.

Washington. In Washington State, the Company offers video lottery terminals operated in conjunction with local central determinant systems, pursuant to compacts between the state and certain Native American tribes in that state. These compacts are recognized by IGRA to permit Class III gaming, which would otherwise be illegal.

Table of Contents

MULTIMEDIA GAMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Native American Regulation of Gaming. IGRA requires that Native American tribes adopt and submit for NIGC approval gaming ordinances that regulate tribes' conduct of gaming. While these ordinances vary from tribe to tribe, they commonly provide for the following:

Native American ownership of the gaming operation;

Establishment of an independent tribal gaming commission;

Use of gaming net revenues for Native American government, economic development, health, education, housing or related purposes;

Independent audits, including specific audits of all contracts for amounts greater than \$25,000;

Native American background investigations and licenses;

Adequate safeguards for the environment and the public health and safety; and

Dispute resolution procedures.

Other. Existing federal and state regulations may also impose civil and criminal sanctions for various activities prohibited in connection with gaming operations, including false statements on applications, and failure or refusal to obtain necessary licenses described in the regulations.

Development Agreements

To date, the Company has entered into development agreements to provide up to \$98.1 million towards the construction and/or remodel of eleven gaming facilities, and had advanced \$29.2 million under these agreements. In exchange for a certain amount of the funds advanced under the development agreement, the Company receives a guarantee of floor space for its player terminals. A portion of the hold per day generated by these player terminals is used to repay the construction advance. Consequently, the payback period is dependent on the hold per day generated by the Company's player terminals located on the guaranteed floor space. The Company is in various stages of discussion with new and existing customers to provide funding for similar opportunities under joint development agreements. For further discussion regarding the Company's development agreements, see Part 1 Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Risk Factors.

Off Balance Sheet Arrangements

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

As of June 30, 2004, the Company had \$1.0 million in outstanding letters of credit issued under the Revolver to guarantee its performance under certain contracts.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We are a leading supplier of interactive, electronic gaming systems to the rapidly growing Native American gaming market and to the charity and commercial bingo and state video lottery markets. We design and develop hardware, software, networks and content that provide our customers with a comprehensive gaming system. Historically, we have focused our efforts on Class II gaming systems and Class III video lottery systems used primarily by Native American tribes.

We derive the majority of our gaming revenues from the placement of player terminals and Point-of-Sale terminals, or POSTs, and back office equipment, which we collectively refer to as gaming systems, under participation arrangements, and to a lesser degree from the placement of video lottery terminals, or VLTs, in the Class III market in Washington State under lease-purchase or participation arrangements, and from the back-office fees generated by those video lottery systems. We also generate gaming revenues in return for providing the central determinant system for a network of VLTs operated by the New York State Division of the Lottery. A significantly smaller portion of our revenues is generated from the sale of VLTs and game licenses in the Class III market in Washington State, except for a relatively few periods during which market conditions result in a temporary increase in the number of VLTs sold during the period (e.g., the opening of a new casino, or a change in the law that allows existing casinos to increase the number of VLTs permitted under prior law.)

Native American Gaming Market

The Native American gaming market is a highly fragmented segment of the overall gaming industry in the United States. Though not all of the over 550 federally recognized Native American tribes offer gaming, there are over 300 Class II and Class III gaming facilities throughout the United States, with the majority of tribes operating only one facility.

Native American gaming is governed by the Indian Gaming Regulatory Act of 1988, or IGRA, which also established the National Indian Gaming Commission, or NIGC, with certain regulatory powers over Native American gaming. IGRA classifies games that may be played on Native American lands into three categories, each of which is subject to different regulations as follows:

Class I Gaming. Class I gaming includes traditional Native American social and ceremonial games. Class I gaming is regulated exclusively at the Native American tribe level.

Class II Gaming. Class II gaming includes bingo and, if played at the same location where bingo is offered, pull-tabs and other games similar to bingo. Class II gaming is regulated by the individual Native American tribes, with NIGC having oversight of the tribal regulatory process. States that allow bingo and games similar to bingo to be conducted by any other entity or for any other purposes, such as at charities or schools, may not regulate Class II gaming, and therefore receive no tax revenues from income the tribes derive from Class II gaming.

Class III Gaming. Class III gaming includes all other forms of gaming that are not included in either Class I or Class II, including slot machines and most table games. Class III gaming may be conducted only pursuant to compacts negotiated between individual states and individual Native American tribes located within that state. The compacts typically include provisions entitling the state to receive taxes at an agreed-upon rate from the income a tribe derives from Class III gaming activities.

Class II Market. We derive our Class II gaming revenues primarily from participation arrangements with our Native American customers. Under participation arrangements, we retain ownership of the player terminals installed at our customers' tribal gaming facilities, and receive revenue based on a percentage of the hold per day generated by each gaming system. The network-wide hold of all of these gaming systems is reported by us as Gaming revenue - Class II, and represents the total amount end users wager, less the total amount paid to end users for prizes. The amounts retained by the facilities for their share of the hold are included in our results of operations as part of Allotments to facility operators, and are deducted from our total revenues to arrive at our net revenues. We believe that net revenue and our net revenue per player terminal per day are the most important factors in evaluating our Class II market performance. Net revenue per player terminal per day represents total gaming revenues less allotments to facility operators, divided by the average number of player terminals and the number of days in the period.

Table of Contents

Our historical revenue growth is a reflection of the increase in our installed base of player terminals in the Class II market, and the technological advances we have developed and implemented. These advances have enabled us to dramatically increase the frequency and the number of games played on our system over any given period of time. Our gaming systems enable us to launch new games rapidly, with moderate cost, which we believe provide end users with greater levels of entertainment. We believe that this leads to a greater number of end users, and their receiving more perceived value from their entertainment dollar.

Our New Generation gaming system operates at a speed considerably faster than our Legacy system, generally resulting in end users playing a greater number of games on our New Generation system in the same amount of time. As a result of the faster speed of play and higher payout ratios, we believe that end users derive a higher level of satisfaction from playing our New Generation games. We believe that this enhanced satisfaction results in end users playing more games and for longer periods of time than on our Legacy system, resulting in higher net revenue per player terminal on our New Generation system. In November 2003, we introduced and began deploying our Gen4 back-office system, which enables us to produce games with bonus rounds and wide-area progressives, provides more end-user enjoyment and also provides better networking capabilities among gaming systems.

As the market grows, and the rules and regulations governing Class II gaming are clarified by court decisions and by improved rule-making procedures, we believe new competitors with significant gaming experience and financial resources will enter the Class II market. New tribal-state compacts may also lead to increased competition from such competitors. In addition, we are experiencing an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue to compete against games that do not appear to comply with published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, we have and may continue to experience pressure on our pricing model with the result that gaming providers are competing on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and more entertaining games with technological enhancements that we believe will appeal to end users, we believe that the level of net revenue retained by our customers from their installed base of player terminals will become a more significant competitive factor, one that may require us to change the terms of our participation arrangements with customers. Consequently, we believe that a simple business model based upon the average hold per player terminal per day will become less relevant in predicting our performance, as our participation arrangements with customers become less standardized and more complex.

In May 1996, we introduced our Class II MegaMania game, the first in a series of high-speed, interactive bingo games that are based on our Legacy gaming system, and played on player terminals linked with one another via nationwide, broadband telecommunications network. In January 2001, we introduced our MegaNanza game, a New-Generation bonanza-style bingo game, in which the balls were drawn before the bingo cards were purchased. MegaNanza played faster than our Legacy games, and generated increased revenues for us and our customers. In June 2002, we introduced Reel Time Bingo, a New-Generation-based, high-speed, standard-sequence bingo game, in which the cards are purchased before the balls are drawn. During October 2003, both in response to a settlement agreement with the NIGC regarding the continued play of MegaNanza, and to take advantage of improved technologies, we completed the conversion of our MegaNanza games to versions of Reel Time Bingo. The conversion was accomplished relatively smoothly, as MegaNanza and Reel Time Bingo both operate on our New Generation gaming system, which, among other benefits, allows game conversion to be achieved by loading new software, either from our network operations center or at the customer's gaming facility.

Class III Market. The majority of our Class III VLTs in Washington State have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as Player terminal and license sale and lease revenue. Certain game themes we use in the Class III market have been licensed from third parties and are resold to customers along with our Class III VLTs. Revenues from the sale of Class III VLTs and the sale of terminal licenses are recognized when the units are delivered to the customer, and the licensed games installed. To a considerably lesser extent, we also enter into either participation arrangements or lease-purchase arrangements for our Class III VLTs, on terms similar to those used for our gaming systems in the Class II market.

We also receive back-office fees based on a share of the hold per day from both leased and sold VLTs in Washington State. Back-office fees cover the service and maintenance costs for back-office servers installed in each hall to run our Class III games, as well as the cost of related

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

software updates. These back-office fees are reported in our results of operations as part of Gaming revenue All other. For those VLTs sold to our customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share we receive

-18-

Table of Contents

from terminals being rented under participation agreements. Accordingly, we derive our Class III revenues to a greater extent from VLT sales than from participation-based back-office fees.

In June 1999, we installed our first Class III VLTs in Washington State, which was the first state where Class III video lottery systems were permitted by Native American-state compact. During 2000, we had significant sales of Class III VLTs, as initial sales were made pursuant to newly adopted Native American compacts with Washington State, which specifically limited the number of installed Class III VLTs permitted on Native American land. As new casinos are introduced into the Washington market or existing casinos are expanded, and as the compact limitations on the number of installed VLTs are eased, we have experienced brief periods of temporary increases in the number of VLTs sold, thereby resulting in anomalies when one period is compared to another. We believe similar occurrences may result in fluctuations in our Class III VLT sales in the future.

In December 2003, we installed the first POSTs for our new Tribal Instant Lottery Game, or TILG, in California. The new one-touch game is based on a simulated scratch-off lottery ticket, and employs our central determinant system technology. Similar to our arrangements with our tribal customers in the Class II market, the aggregate hold for the TILG is reported by us as part of Gaming revenue All other, and represents the total amount end users wager, less the total amount paid to end users for prizes. The amounts retained by the facilities for their share of the hold are included in our results of operations as part of Allotments to facility operators, and are deducted from our total revenues to arrive at our net revenues.

Charity and Commercial Bingo Market

In December 2003, we installed our first electronic bingo player terminals for the charity market in Alabama. In November 2003, voters in Macon County approved a constitutional amendment authorizing the operation of bingo games by non-profit organizations for charitable, educational and other lawful purposes. The new electronic bingo player terminals run on our Gen4 back-office system. The aggregate hold from charity bingo is reported by us as part of Gaming revenue All other, and represents the total amount end users wager, less the total amount paid to end users for bingo prizes. The amounts retained by the facilities for their share of the hold are included in our results of operations as part of Allotments to facility operators, and are deducted from our total revenues to arrive at our net revenues.

State Video Lottery Market

We designed and developed a central determinant system for the emerging state video lottery market. Our central system encompasses all software, hardware and networks required to provide outcomes and accounting for video lottery gaming conducted at multiple locations. Beginning in January 2004, we began the first operation of our central determinant system for the video lottery terminal network that the New York Lottery operates at licensed New York State racino racetracks. Our central system is able to interface with and manage VLTs provided by Bally Gaming Inc., International Game Technology, Sierra Design Group, and Spielo Gaming International. As payment for providing and maintaining the central determinant system, we receive a small portion of the network-wide hold per day. Our portion of the revenue is reported by us as part of Gaming revenue All other. We believe that we will be able to achieve future growth in the state video lottery market by leveraging our experience in the states of Washington and New York, our leadership in technologically advanced game and system design, and our ability to rapidly adapt game and system technology to satisfy emerging regulatory requirements.

Development Agreements

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

As we seek to continue the growth in our customer base and to expand our installed base of linked player terminals, a key element of our strategy has become entering into joint development agreements with various Native American tribes to help fund new or expand existing tribal gaming facilities. Pursuant to these agreements, we advance funds to the tribes for the construction of new tribal gaming facilities or for the expansion of existing facilities. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances.

Amounts advanced that are in excess of those reimbursed by such tribes for real property and land improvements are allocated to an other asset and amortized over the life of the contract. Amounts advanced that relate to personal property owned by us and located at the tribal gaming facility are carried in our property and equipment and depreciated over the estimated useful life of the asset.

Table of Contents

In return for the amounts advanced by us, a percentage of the gaming facility's floor space is guaranteed for our player terminals, and we receive a fixed percentage of the hold per day from those units over the term of the agreement. Certain of the agreements contain performance standards for our player terminals that could allow the facility to reduce a portion of our dedicated floor space. To date, we have signed agreements for eleven such facilities, for an aggregate commitment to advance approximately \$98.1 million.

We are in various stages of discussion with new and existing tribal customers to provide funding for similar opportunities under additional joint development agreements. For further discussion regarding our development agreements, see Part 1 Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Risk Factors.

License Agreements

We have license agreements with WMS® Gaming, Inc., or WMS, and Bally Gaming Inc., or Bally, to use certain trademarks, logos and graphics in our Class III games. We, in turn, resell these licenses to our customers in connection with the installation of our Class III VLTs that use these licenses. Revenues from the sale of these licenses by us are reported in our results of operations under Player terminal and license sale and lease revenue. We also have a similar license agreement for the Class II market with Bally, WMS, and Mikohn Gaming Corporation. Because we generally install our Class II player terminals and games with our customers on a participation arrangement basis, thereby retaining ownership of the player terminals, we do not resell licenses for use in the Class II market.

Research and Development

Research and development activities primarily relate to the development of new gaming systems, gaming engines, player tracking systems, casino data management systems, central video lottery systems, gaming platforms and content, and enhancements to our existing product lines. Research and development costs consist primarily of salaries and benefits, consulting fees, and an allocation of corporate facilities costs related to these activities. Once the technological feasibility of a project has been established, the project is transferred from research to development, and capitalization begins.

Research and development expenses increased by 28.6% to \$3.2 million for the three months ended June 30, 2004, from \$2.5 million for the comparable period in the prior fiscal year. For the nine months ended June 30, 2004, research and development expenses increased by 19.3% to \$8.9 million, from \$7.5 million for the same period of 2003. This increase primarily resulted from an increased headcount in our development group as we have focused our internal efforts on developing new gaming systems and game themes. We expect our research and development expenses to grow over the upcoming periods as we continue focusing on product development and adding development staff.

Recent Developments

DOJ Action. On November 21, 2003, the DOJ filed a Petition for a Writ of Certiorari in the Supreme Court seeking review of two U.S. circuit court cases that examined whether the Johnson Act prohibits Native American tribes from offering certain types of electronic gaming devices. Specifically, the DOJ sought review of *United States of America v. Santee Sioux Tribe of Nebraska, a Federally Recognized Indian Tribe*, on Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit, and *John D. Ashcroft, Attorney General, et al., v Seneca-Cayuga Tribe of Oklahoma, et al.* on Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit. In the petitions, the DOJ asserted that the Johnson Act prohibits Native American tribes from operating certain electronic gambling devices without a

compact with the appropriate state.

On February 27, 2004, the Supreme Court declined to grant the DOJ's Petitions for Writs of Certiorari. Although our machines were not the subject of the lawsuits, the DOJ's arguments and reasoning appeared to encompass the machines we offer for the Class II market. Since the Supreme Court has declined to accept these cases for review, the lower courts' decisions affirming the right of the tribes to offer games such as those we manufacture and sell as legal electronic aids to bingo for the Class II market will continue to stand. We believe that for the immediate future, significant legal uncertainty has been eliminated concerning our ability to continue to offer Class II games played with the assistance of technological aids in our principal market. However, the elimination of this legal uncertainty could also result in increased competition from vendors currently in the Class III market who we believe have avoided entry into the Class II market due to the legal uncertainties described above.

Table of Contents

Oklahoma Tribal-State Compact. In February 2004, legislation authorizing certain forms of gaming at racetracks, and additional types of games at tribal gaming facilities in the state, or the Bill, was approved in Oklahoma. The Bill was originally scheduled to become effective 90 days after the end of the current legislative session, which expired at the end of May 2004. However, in May 2004, the Bill was repealed by the Oklahoma Legislature and substitute legislation was passed that requires a statewide referendum in November 2004. Certain groups opposed to the legislation have vowed to both fight the new bills and to attempt to delay the enactment of the new legislation. As a result, we are unable to determine when or if any new legislation authorizing certain forms of gaming at Oklahoma racetracks and additional types of games at tribal gaming facilities will become effective.

The majority of our revenue is generated from the placement of Class II gaming systems with tribal customers who are currently not parties to any state compact that would permit them to offer Class III games. Although the proposed Oklahoma compact specifically excludes slot machines, the new legislation will permit tribes in Oklahoma, who enter into a compact with the state, to offer games other than the Class II games that we have historically offered in that state, including video poker and certain table games. Although we believe the new legislation will enable us to offer a broader range of games to our tribal customers in Oklahoma, we also expect the new legislation will bring intensified competition into the Oklahoma market, including new competition from credible gaming industry participants that to date have only had a limited presence in that market. In addition, we are experiencing an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue to compete against games that do not appear to comply with published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, we have and may continue to experience pressure on our pricing model. New opportunities in the Oklahoma market resulting from the recent legislation may not develop as we anticipate, or may take longer to develop than we expected.

NIGC. On April 23, 2004 we reported that the acting General Counsel of the NIGC had issued a letter to us and one of our tribal customers opining that our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with the acting General Counsel's interpretation, and our belief that her view of management is broader than was intended by Congress. We also believe that the acting General Counsel's opinion may be based, in part, on collateral agreements that we provided to the NIGC in error and that are not presently in effect. We, along with certain tribal customers, have submitted additional information and documents related to our development agreements for review by the NIGC. If certain of our development agreements are finally determined to be management contracts, there could be material adverse consequences to us. In that event, we may be required to modify the terms of such agreements. Such modification may adversely affect the terms on which we conduct business and significantly impact our financial condition and results of operations from such agreement and from other development agreements that may be similarly interpreted by the NIGC.

Lytton Rancheria Loan. In October 2003, we provided a bridge loan to the Lytton Rancheria of California, or Lytton Rancheria, a federally recognized Native American tribe, which the tribe used to facilitate the transfer of land in San Pablo, California to the United States in trust for Lytton Rancheria. In December 2003, based upon certain triggering events in the loan agreement, the bridge loan converted to a term loan. As a result of the conversion, Lytton Rancheria began to make interest-only payments at Prime plus 2% in January 2004. The loan was paid in full in March 2004.

Table of Contents**RESULTS OF OPERATIONS**

The following tables outline our end-of-period and average installed base of gaming terminals for the three and nine months ended June 30, 2004 and 2003:

	Period Ended	
	June 30,	
	2004	2003
End-of-period installed Gaming terminal base:		
Class II player terminals		
Reel Time Bingo	8,686	6,686
MegaNanza		883
New Generation system	8,686	7,569
Legacy system	1,009	1,675
Other player terminals and POSTs	1,996	
Class III video lottery terminals	3,180	2,455

	Three Months Ended		Nine Months Ended	
	June 30,		June 30,	
	2004	2003	2004	2003
Average installed gaming terminal base:				
Class II player terminals				
Reel Time Bingo	8,793	5,840	8,752	3,505
MegaNanza		1,112	27	2,836
New Generation system	8,793	6,952	8,779	6,341
Legacy system	1,124	1,731	1,255	2,068
Other player terminals and POSTs	1,639		923	
Class III video lottery terminals	3,162	2,244	3,037	2,156

Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003

Total revenues for the three months ended June 30, 2004 were \$123.5 million, compared to \$96.0 million for the same period in fiscal 2003, a 29% increase. This was primarily due to an increase in Class II gaming revenues, our entry into the charitable bingo market and the introduction of our Tribal Instant Lottery Game, or TILG, as described below.

Gaming Revenue Class II

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Class II gaming revenues increased by \$15.6 million, or 19%, from \$82.1 million in the three months ended June 30, 2003 to \$97.7 million in the three months ended June 30, 2004, due primarily to an increase in the number of installed New Generation games.

New Generation system revenues, which include Reel Time Bingo and MegaNanza games, were \$90.4 million for the quarter ended June 30, 2004, compared to \$72.3 million in the quarter ended June 30, 2003, a 25% increase. This was based primarily on an increase in the average number of player terminals in daily operation during each of the respective periods from 6,952 to 8,793.

An average of 1,124 Legacy player terminals were in daily operation, a 35% decrease from 1,731 in the same period of fiscal 2003, as tribal gaming facilities continued to replace Legacy player terminals with higher-performing units.

Gaming Revenue All Other

Class III rental and back office fees increased 10% to \$1.2 million in the three months ended June 30, 2004, from \$1.1 million during the same period of 2003.

Other recurring gaming revenue generated from the charity bingo market, TILG and the central determinant system for the New York Lottery increased to \$23.1 million for the quarter ended June 30, 2004, compared to no revenues in same quarter of 2003. The increase relates to our expansion into the charity bingo market and the launches of TILG and the New York lottery system late in the first quarter of fiscal 2004.

Player Terminal and License Sale and Lease Revenue

Player terminal and license sale and lease revenue decreased to \$805,000, from \$12.5 million in the same period of 2003. During the quarter ended June 30, 2003, two customers opened new facilities, and a lease-purchase customer converted to a purchase, resulting in the sale of 1,062 video lottery terminals. In the

Table of Contents

same quarter of the current fiscal year 30 video lottery terminals were sold, resulting in player terminal sales and miscellaneous equipment sales revenue of \$158,000. The lower number of video lottery terminals sold in the current quarter resulted in a decrease in license sales from \$2.5 million in fiscal 2003 to \$488,000 in fiscal 2004.

Other revenue, which consisted primarily of service and maintenance fees, increased 93% to \$740,000 for the three months ended June 30, 2004, from \$384,000 in the same period of 2003. The increase is due to the collection of modular rent beginning May 2004, and service contract income related to video lottery terminals beginning August 2003.

Allotments to facility operators increased 49% to \$86.6 million for the three months ended June 30, 2004, from \$58.0 million in the same period of 2003. Virtually all of this increase was attributable to the increase in commissions related to gaming revenues and is commensurate with the overall increase in gaming revenue.

Bingo prizes and related costs decreased to zero for the three months ended June 30, 2004, from \$68,000 in the same period of 2003. The decrease was caused by the MegaBingo game being discontinued during fiscal 2003.

Cost of player terminal and licenses sold decreased to \$967,000 for the three months ended June 30, 2004, from \$7.3 million in the same period of 2003. The decrease relates to reduced sales of equipment and licenses during the third quarter of 2004, compared to the same period in 2003.

Selling, general and administrative expenses increased 22% to \$13.0 million for the three months ended June 30, 2004, from \$10.6 million in the same period of 2003, primarily resulting from the increase in personnel hired to address our gaming network and development needs, and the increased business activity resulting from our entrance into new markets. Third quarter 2004 selling, general and administrative expenses benefited from a reduction of the fiscal 2004 incentive accrual and the resulting reversal of \$1.4 million in compensation from the first six months of the fiscal year. Salaries, wages and employee benefits increased approximately \$1.7 million, due to additional personnel hired to address our gaming network and development needs and the pursuit of new business. At June 30, 2004, we employed 414 full-time and part-time employees, compared to 316 at June 30, 2003. Travel costs increased approximately \$183,000, due to the greater number of employees, the pursuit of new business, and the temporary assignment of employees to New York. Advertising and promotions costs increased \$196,000 as the result of our entrance into new markets. Legal, professional and lobbying fees increased approximately \$229,000, primarily as a result of increased legal and professional services related to our research of new products and entry into new markets.

Amortization and depreciation expense increased 72% to \$9.5 million for the three months ended June 30, 2004, from \$5.5 million for the same period of 2003, primarily as a result of a 33% increase in the average installed base of terminals under participation arrangements.

Interest income increased to \$178,000 for the three months ended June 30, 2004, from \$71,000 in the same period of 2003. The increase was primarily related to interest accrued on notes receivable and the higher cash balances.

Interest expense increased to \$429,000 for the third fiscal quarter of 2004, from \$187,000 for the same quarter of fiscal 2003, due to an increase in long-term debt and capital leases in fiscal 2004. As we continue to fund our capital commitments pursuant to our development agreements and otherwise, we will likely be required to borrow more money under our credit facility. As a result, our interest expense will likely continue to increase in the future.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Income tax expense decreased to \$3.5 million for the three months ended June 30, 2004, from \$5.5 million in the same period of 2003. These figures represent effective tax rates of 26.0% and 38.3% for the three months ended June 30, 2004 and 2003. Income tax expense for the June 30, 2004 quarter includes a benefit of approximately \$1.7 million relating to an over-accrual from prior years' state and federal income tax provision, which resulted in a lower-than-expected effective rate.

Nine Months Ended June 30, 2004 Compared to Nine Months Ended June 30, 2003

Total revenues for the nine months ended June 30, 2004 were \$355.7 million, compared to \$269.6 million for the same period in fiscal 2003, a 32% increase. This was primarily due to an increase in Class II gaming revenues and our entry into the charitable bingo market and the introduction of TILG, as described below.

Table of Contents

Gaming Revenue Class II

Class II gaming revenues increased by \$53.2 million, or 21%, from \$249.7 million in the nine months ended June 30, 2003 to \$302.9 million in the nine months ended June 30, 2004, due primarily to an increase in the number of installed New Generation games.

New Generation system revenues were \$278.9 million for the nine months ended June 30, 2004, compared to \$218.1 million in the same period of fiscal 2003, a 28% increase based primarily on an increase in the average number of player terminals in daily operation during each of the respective periods from 6,341 to 8,779.

An average of 1,255 Legacy player terminals were in daily operation, a 39% decrease from 2,068 in the same period of fiscal 2003, as tribal gaming facilities continued to replace Legacy player terminals with higher-performing units.

There were no television bingo game show revenues during the nine months ended June 30, 2004, compared to \$392,000 in the same period of fiscal 2003. The decrease in MegaBingo revenues was the result of discontinuing game play and holding the final MegaBingo championship game in April 2003.

Gaming Revenue All Other

Class III rental and back office fees increased 22% to \$3.8 million in the nine months ended June 30, 2004, from \$3.1 million during the same period of 2003.

Other recurring gaming revenue generated from the charity bingo market, TILG and the central determinant system for the New York Lottery increased to \$40.3 million for the nine months ended June 30, 2004, compared to no revenues in same period of 2003. The increase relates to our expansion into the charity bingo market and the launches of TILG and the New York lottery system late in the first quarter of fiscal 2004.

Player Terminal and License Sale and Lease Revenue

Player terminal and license sale and lease revenue decreased to \$7.2 million, from \$15.6 million in the same period of 2003. During the nine months ended June 30, 2003, equipment sales totaled \$11.9 million. In the same period of the current fiscal year, 487 video lottery terminals were sold, resulting in player terminal sales and miscellaneous equipment sales revenue of \$4.8 million. License sales decreased from \$3.4 million in fiscal 2003, to \$1.9 million in fiscal 2004. In the third quarter of 2003, two customers opened new facilities, and a lease-purchase customer converted to a purchase, resulting in the sale of licenses and 1,062 video lottery terminals.

Other revenue, which consisted primarily of service and maintenance fees, increased 43% to \$1.6 million for the nine months ended June 30, 2004, from \$1.1 million in the same period of 2003.

Allotments to facility operators increased 39% to \$244.7 million for the nine months ended June 30, 2004, from \$175.6 million in the same period of 2003. Virtually all of this increase was attributable to the increase in commissions related to gaming revenues and is commensurate with the overall increase in gaming revenue.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Bingo prizes and related costs decreased to zero for the nine months ended June 30, 2004, from \$1.2 million in the same period of 2003. The decrease was caused by the MegaBingo game being discontinued during fiscal 2003.

Cost of player terminal and licenses sold decreased to \$5.1 million for the nine months ended June 30, 2004, from \$8.7 million in the same period of 2003. The decrease relates to reduced sales of equipment and licenses during the nine months of 2004, compared to the same period in 2003.

Selling, general and administrative expenses increased 41% to \$41.8 million for the nine months ended June 30, 2004, from \$29.7 million in the same period of 2003, which was primarily the result of the increase in personnel hired to address our gaming network and development needs and increased business activity resulting from our entrance into new markets. During the third quarter of fiscal 2004, selling, general and administrative expenses benefited from a reduction of the fiscal 2004 incentive accrual and the resulting reversal of \$1.4 million in compensation from the first six months of the fiscal year. Salaries, wages and employee benefits increased approximately \$5.6 million, due to additional personnel hired to address our gaming network and development needs and the pursuit of new business. At June 30, 2004, we employed 414 full-time and part-time employees, compared to 316 at June 30, 2003. The increased number of player stations in the field has increased repairs and

Table of Contents

maintenance, shipping and inventory costs by \$2.2 million. Travel costs increased approximately \$966,000, due to the greater number of employees, the pursuit of new business and the temporary assignment of employees to New York. Advertising and promotions costs increased \$1.0 million as the result of our entrance into new markets. Legal, professional and lobbying fees increased approximately \$1.2 million, primarily as a result of increased legal and professional services related to our research of new products and entry into new markets.

Amortization and depreciation expense increased 68% to \$25.3 million for the nine months ended June 30, 2004, from \$15.1 million for the same period of 2003, primarily as a result of a 30% increase in the average installed base of terminals under participation arrangements.

Interest income increased to \$906,000 for the nine months ended June 30, 2004, from \$263,000 in the same period of 2003. The increase was primarily related to interest accrued on the advances made under the Lytton Rancheria loan.

Interest expense increased to \$1.1 million for the nine months ended June 30, 2004, from \$245,000 for the same period of fiscal 2003, due to an increase in long-term debt and capital leases in fiscal 2004. As we continue to fund our capital commitments pursuant to our development agreements and otherwise, we will likely be required to borrow more money under our credit facility. As a result, our interest expense will likely continue to increase in the future.

Income tax expense decreased to \$13.0 million for the nine months ended June 30, 2004, from \$15.0 million in the same period of 2003. These figures represent effective tax rates of 33.7% and 38.3% for the nine months ended June 30, 2004 and 2003, respectively. Income tax expense for the nine months ended June 30, 2004 includes a benefit of approximately \$1.7 million relating to an over-accrual from prior years state and federal income tax provision.

CRITICAL ACCOUNTING POLICIES

We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the U.S. As such, we are required to make certain estimates, judgments and assumptions that we believe are reasonable based on the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the periods presented. There can be no assurance that actual results will not differ from those estimates. We believe the following represent our most critical accounting policies:

Revenue Recognition. We derive our gaming revenues primarily from participation arrangements with our customers. Under participation arrangements, we retain ownership of the gaming systems installed at our customer gaming facilities, and receive revenue based on a percentage of the hold per day generated by each gaming system. We report the network-wide hold of all of these gaming systems as gaming revenue. Participation revenue generated from our Class II customers is reported in our results of operations as Gaming revenue Class II, while revenue from charity customers and our TILG product are included in Gaming revenue All other. The hold represents the total amount end users wager, less the total amount paid to end users for prizes. Amounts retained by tribal and charity gaming facilities for their share of the hold are reported in our results of operations as a part of Allotments to facility operators, and are deducted from our total revenues to arrive at our net revenues.

We generate gaming revenues from the state video lottery market by providing the central determinant system for the video lottery terminal network. In return for providing the system, we receive a small portion of the network-wide hold which is reported in our financial results of operations as a part of Gaming revenue All other.

The majority of our Class III VLTs in Washington State have been sold to customers outright, for a one-time purchase price, and are reported in our results of operations as Player terminal and license sale and lease revenue. Certain game themes we use in the Class III market have been licensed from third parties and the licenses are resold to customers along with our Class III VLTs. Revenues from the sale of Class III VLTs and the sale of player terminal licenses are recognized provided the four basic revenue criteria have been met: a) persuasive evidence of an arrangement exists; b) delivery has occurred and services have been rendered; c) the seller's price is fixed or determinable; and d) collectibility is reasonably assured. For the remainder of our Class III VLTs, we either enter into participation arrangements or into lease-purchase arrangements. Under lease-purchase arrangements, we receive a series of lease payments based on a

Table of Contents

percentage of the customer's hold per day generated from the leased VLTs. At the end of the lease period, we transfer VLT ownership to the customer.

In the Class III market, we also receive back-office fees based on a share of the hold per day from both leased and sold Class III VLTs. Back-office fees cover the service and maintenance costs for the back-office servers we install in each facility to run our Class III games, as well as the related cost of software updates. These back-office fees are reported in our results of operations as Gaming revenue All other. For those VLTs sold to our customers, the back-office fees are based on a considerably smaller percentage of the hold per day than the revenue share we receive from terminals being rented under participation arrangements. Accordingly, we derive our Class III revenues to a greater extent from VLT sales than from participation-based back-office fees.

Property and Equipment. We state property and equipment at cost. The cost of property and equipment is depreciated over their estimated useful lives generally using the straight-line method for financial reporting, and accelerated methods for tax reporting purposes. A substantial portion of our property and equipment is depreciated over two to seven years. Player terminals placed with customers under lease arrangements where player terminal ownership is conveyed to the customer at the end of the lease term is depreciated over the shorter of the lease term or three years. Property and equipment includes a pool of rental terminals, i.e., the rental pool. Rental pool units are those which have previously been in the field, but are currently back at our facility being refurbished and/or awaiting redeployment. Routine maintenance of property and equipment is expensed in the period incurred, while major component upgrades are capitalized and depreciated over the estimated useful life of the component. Sales and retirements of depreciable property and equipment are recorded by removing the related cost and accumulated depreciation from the accounts. Gains or losses on sales and retirements of property are reflected in operations.

We state internally developed gaming software at cost, which we amortize over the estimated useful life of the software, generally using the straight-line method. We amortize internally developed games over an eighteen-month period, gaming systems and engines over a three-year period, and our central management systems over a five-year period. We capitalize software development costs once technological feasibility has been established, and begin amortizing the software once in service. We expense any subsequent software maintenance costs, such as bug fixes and subsequent testing, as incurred. Software development projects that are discontinued are expensed at the time the determination to discontinue is made.

We review our property and equipment for impairment whenever events or changes in circumstances indicate we may not recover the carrying amount of an asset. We measure recoverability of assets to be held and used by comparing the carrying amount of an asset to future cash flows expected to be generated by the asset. If we determine an asset to be impaired, we measure the impairment as the amount by which the carrying amount of the assets exceeds their fair value, considering the discounted future net cash flows. We report assets to be disposed of at the lower of the carrying amount or the fair value, less costs of disposal.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts related to our accounts receivable and notes receivable that have been deemed to have a high risk of collectibility. We review our accounts receivable and notes receivable on a monthly basis to determine if any receivables will potentially be uncollectible. We analyze historical collection trends, and changes in our customers' payment patterns, customer concentration, and credit worthiness when evaluating the adequacy of our allowance for doubtful accounts. We include any receivable balances that are determined to be uncollectible in our overall allowance for doubtful accounts.

Inventory Reserves. Inventories are stated at the lower of cost (first in, first out) or market. We regularly review our inventory quantities on hand and record reserves for excess and obsolete inventory based primarily on our estimated forecast of product demand and production and service requirements.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Stock-Based Compensation. We apply Accounting Principles Board Opinion, or APB, No. 25 in accounting for our stock option plans, rather than the alternative fair value accounting provided under SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under APB No. 25, no compensation expense is recognized for grants of options to common-law employees and directors at an exercise price equal to or greater than the market price of the stock on the date of grant. Accordingly, based on our grants to employees in the three and nine months ended June 30, 2004 and 2003, no compensation expense has been recognized.

-26-

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2004, we had unrestricted cash and cash equivalents of \$29.6 million, compared to \$26.3 million at September 30, 2003. Our working capital at June 30, 2004 was \$16.9 million, compared to \$18.5 million at September 30, 2003.

As of June 30, 2004, our total contractual cash obligations were as follows (in thousands):

	Less than		More than		Total
	1 year	1-3 years	3-5 years	5 years	
Long-term debt ⁽¹⁾	\$ 5,823	\$ 6,601	\$ 1,111	\$	\$ 13,535
Capital leases ⁽²⁾	4,374	5,754			10,128
Operating leases ⁽³⁾	1,333	2,627	2,471	441	6,872
Purchase commitments ⁽⁴⁾	6,700	10,500			17,200
Payments due under employment agreement ⁽⁵⁾	250	500	500	2,396	3,646
Gaming facility joint development agreements ⁽⁶⁾	68,933				68,933
Total	\$ 87,413	\$ 36,482	\$ 4,082	\$ 2,837	\$ 120,314

(1) Consists of various three to five year loans for the purchase of automobiles and property and equipment at an overall average annual interest rate of 8.11%, a five-year loan related to financing our corporate aircraft at an annual interest rate of LIBOR plus 2.75%, and amounts borrowed under our credit facility at an annual interest rate of Prime plus 1.25% with a floor of 5.5%.

(2) Consists of various three-year capital leases for property and equipment at an overall average annual interest rate of 7.82%.

(3) Consists of operating leases for our facilities and office equipment that expire at various times through 2009.

(4) Consists of commitments to purchase third-party licenses and player terminals.

(5) Represents the expected future payments due, based on life expectancy tables, to Gordon Graves for his non-compete agreement entered into under his Employment Agreement.

(6) Represents commitments for payments toward development and construction and/or expansion of tribal gaming facilities. For purposes of this table, cash obligations under development agreements are considered payable over the next twelve months, although the actual timing of the payments may extend beyond twelve months, depending on the number and schedule of development projects ongoing at any given time.

During the nine months ended June 30, 2004, we generated \$23.4 million in cash from our operations, compared to \$22.8 million during the same period of 2003. This \$626,000 increase in cash generated from operations over the prior period was primarily the result of the payment timing related to purchases of inventory and accounts payable, as well as the timing of accounts receivable collections.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

Cash used in investing activities increased to \$40.4 million in the nine months ended June 30, 2004, from \$25.8 million in the same period of 2003. The increase resulted from a \$10.5 million increase in cash capital expenditures, to \$31.5 million for the nine months ended June 30, 2004, from \$21.0 million in the same period of fiscal 2003. This amount, combined with net amounts of \$9.4 million, advanced under development agreements in the first, second and third quarter of fiscal 2004, compared to \$4.8 million advanced in the first, second and third quarter of fiscal 2003, accounted for the overall increase. During the nine months ended June 30, 2004, additions to property and equipment consisted of:

	Cash Capital Expenses	Financed Capital Expenses	Non Cash Transfer of Inventory	Total Additions to PPE
Player terminal and gaming equipment	\$ 18,806	\$ 3,326	\$ 11,644	\$ 33,776
Equipment and third-party software for NY Lottery	1,754	2,929		4,683
Tribal gaming facilities and portable buildings	7,895			7,895
Internally developed software	1,843			1,843
Other	1,169	328		1,497
Total	\$ 31,467	\$ 6,583	\$ 11,644	\$ 49,694

Cash provided by financing activities for the nine months ended June 30, 2004 was \$20.3 million, compared to \$6.7 million in the same period of 2003. For the nine months ended June 30, 2004, we collected \$18.1 million from the exercise of warrants and options and the related tax benefit, compared to \$2.9 million in the same period of fiscal 2003. Cash flow provided by financing activities for the nine months ended June 30, 2004 also included proceeds from long-term debt of \$7.7 million, drawn on the term loans under our credit facility described below.

Table of Contents

Our projected capital expenditures for the next year will consist of player terminals and POSTs and related gaming equipment placed with customers under participation arrangements, and will include substantial capital outlays in connection with the joint development of new and expanded tribal gaming facilities, for the build-out of the central system at certain racetracks for the New York Lottery project described in further detail below, and may include substantial capital expenditures in connection with potential acquisitions. In our strategy to partner with current and prospective customers to jointly develop tribal gaming facilities that will house our player terminals, and in pursuing any potential acquisitions, we may make expenditures that could significantly affect our cash flow and liquidity, and use a significant portion of both our cash flow from operations and any proceeds we receive from debt or equity financing we might undertake. Our total capital expenditures will depend upon the number of player terminals that we are able to place in service during the year, and the number and size of tribal gaming facilities we choose to develop. Additional capital expenditures will be required for player terminals if we are successful in introducing our games into new markets. In addition to manufacturing our own, we also purchase player terminals from Bally and WMS, and licenses from Bally, WMS and Mikohn.

In May 2002, the New York Lottery notified us that it had selected us as the winning vendor to provide the central system for video lottery games to be operated at certain New York State racetracks. In December 2002, we executed a definitive agreement to provide the central system, and submitted it to the New York Lottery. In April 2003, a final approved and signed contract was obtained from the New York State Comptroller and Attorney General. During January 2003, we secured \$12.0 million in vendor-based financing to lease equipment for the New York Lottery project and the build-out of the central system. As of June 30, 2004, we had acquired \$12.5 million of the anticipated \$18.5 million in equipment and third-party software required to develop, produce and implement the central system.

To date, we have entered into development agreements (further described under PART I Item 1. Financial Statements Summary of Significant Accounting Policies) with our customers to provide up to \$98.1 million towards the construction and or remodel of eleven tribal gaming facilities. The agreements typically provide for a portion of the amounts retained by the gaming facility for their share of the hold to be used for repayment of some or all of the advances. As of June 30, 2004, we had advanced a total of \$29.2 million under such agreements, and expect to advance the remaining \$68.9 million over the next twelve to eighteen months.

Our debt structure consists of a credit facility, which provides us with a \$20.0 million term loan facility, or Term Loan, and a \$5.0 million revolving credit line, or the Revolver. The Term Loan can be drawn under three tranches based upon our unfinanced capital expenditures, beginning in June 2003 and closing six months apart. The Term Loan matures in June 2006, bears interest at a rate of Prime plus 1.25%, which was 5.75% as of June 30, 2004, and has a floor of 5.5%. At June 30, 2004, we had drawn \$10.2 million under the first two tranches of the Term Loan. The Revolver provides us with up to \$5.0 million for working capital needs, which is limited by a borrowing base comprised of certain of our accounts receivable and inventory, and bears interest at a rate of Prime plus 1.25%, and has a commitment fee based on the daily average of the unborrowed commitment. The Revolver matures in June 2005. As of June 30, 2004, the borrowing base provided for \$5.0 million in availability; however, there were no outstanding borrowings under the Revolver. In addition, \$1.0 million of the \$5.0 million available under the Revolver has been reserved for a letter of credit in connection with our New York Lottery operations.

The credit facility contains customary financial and operational covenants, and is collateralized by substantially all our assets. We were in compliance with these covenants as of June 30, 2004.

We believe that our existing cash and cash equivalents, cash provided from our operations and amounts available under our credit facility can sustain our current operations, which could include a portion of the financing required from us in connection with our joint development agreements, dependent upon the number and schedule of development projects ongoing at any given time. However, our performance and financial results are, to a certain extent, subject to general conditions in or affecting the Native American gaming industry, and to general economic, political, financial, competitive and regulatory factors beyond our control. If our business does not continue to generate cash flow at current levels, or if the level of funding required in connection with our joint development agreements is greater or proceeds at a pace faster than anticipated, we may need to raise additional financing. We may also need additional financing as a result of entering into new joint development agreements. In order to meet these potential additional capital requirements, we negotiated an increase in the available credit under our existing credit facility. However, this additional credit from our current lender may not be sufficient. Other sources of such additional financing might

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

include additional bank debt or the public or private sale of equity or debt securities. However, sufficient funds may not be available on terms acceptable to us or at all, from these sources or any others to enable us to make necessary capital expenditures and to make discretionary investments in the future.

Table of Contents

Stock Repurchase Authorizations

Our board of directors authorized us to repurchase 900,000 shares of our common stock, effective April 2000, and an additional 3,000,000 shares of our common stock, effective September 2001. The timing and total number of shares repurchased will depend upon prevailing market conditions and other investment opportunities. During fiscal 2002 and 2001, we repurchased 1,212 and 1,663,730 shares of our common stock at an average cost of \$14.17 and \$3.16, respectively. No shares were repurchased on the open market during fiscal 2003. During fiscal 2003, we settled a stockholder's notes receivable in exchange for 61,716 shares of our common stock, at their fair market value of \$10.44 per share at the time of the exchange. During the nine months ended June 30, 2004, we received 22,546 shares of our common stock at a fair market value of \$20.95 per share in consideration for stock options exercised by an employee, and we settled a stockholder's notes receivable in exchange for 65,196 shares of our common stock at a fair market value of \$24.52 per share.

At June 30, 2004, we had approximately 5.3 million options outstanding, with exercise prices ranging from \$0.67 to \$21.53 per share. At June 30, 2004, approximately 2.7 million of the outstanding options were exercisable.

SEASONALITY

We believe our operations are not materially affected by seasonal factors, although we have experienced fluctuations in our revenues from period to period. After the holiday season, (November through December) our revenues generally build steadily, with our last fiscal quarter (July through September) traditionally being our strongest quarter.

CONTINGENCIES

For information regarding contingencies, see PART I Item 1. Financial Statements Commitments and Contingencies and PART II Item 1. Legal Proceedings.

INFLATION AND OTHER COST FACTORS

Our operations have not been, nor are they expected to be, materially affected by inflation. However, our operational expansion is affected by the cost of hardware components, which are not considered to be inflation sensitive, but rather, sensitive to changes in technology and competition in the hardware markets. In addition, we expect to continue to incur increased legal and other similar costs associated with regulatory compliance requirements and the uncertainties present in the operating environment in which we conduct our business.

FUTURE EXPECTATIONS AND FORWARD-LOOKING STATEMENTS

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

This Quarterly Report and the information incorporated herein by reference contains various forward-looking statements within the meaning of federal and state securities laws, including those identified or predicated by the words believes, anticipates, expects, plans, or similar expressions with forward looking connotation. Such statements are subject to a number of risks and uncertainties that could cause the actual results to differ materially from those projected. Such factors include, but are not limited to, the uncertainties inherent to the outcome of any litigation of the type described in this Quarterly Report under PART II Item 1. Legal Proceedings, trends and other expectations described in PART I Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, risk factors disclosed in our earnings and other press releases issued to the public from time to time as well as those other factors as described under Certain Risk Factors set forth below. Given these uncertainties, readers of this Quarterly Report are cautioned not to place undue reliance upon such statements.

CERTAIN RISK FACTORS

The following risk factors could materially and adversely affect our operating results and could cause actual events to differ materially from those predicted in any forward-looking statements related to our business.

We face legal and regulatory uncertainties that threaten our ability to conduct our business and to effectively compete in our Native American gaming markets, that increase our cost of doing business and that divert substantial management time away from our operations.

Historically, we have derived most of our revenue from Class II gaming activities conducted on Native American lands. These activities are subject to federal regulation under the Johnson Act, IGRA, and under the rules and

Table of Contents

regulations adopted by both the NIGC and the gaming commissions each Native American tribe establishes to regulate gaming. These gaming activities are also subject to regulation by state and local authorities, to the extent such gaming activities constitute, or are perceived to constitute, Class III gaming. Class III gaming is illegal in most states, and may only be conducted by a tribe pursuant to a compact between a tribe and the state in which the tribe is located. The Class III video lottery systems we offer, such as the VLTs operating in Washington State, are subject to regulation by authorities in that state and to the terms of the compacts between the tribes offering such games and Washington State. In addition, gaming activities under the new tribal-state compact in Oklahoma, when effective, will be subject to the terms of compacts between such tribes and the state of Oklahoma.

The Johnson Act broadly defines “gambling devices” to include any “machine or mechanical device” designed and manufactured “primarily for use in connection with gambling, and that, when operated, delivers money or other property to a player” as the result of the application of an element of chance. A government agency or court that literally applied this definition and did not give effect to subsequent congressional legislation, or to certain regulatory interpretations or judicial decisions, could determine that the manufacture and use of our electronic player terminals, and perhaps other key components of our Class II gaming systems that rely to some extent upon electronic equipment to run a game, are illegal. Our tribal customers could be subject to significant fines and penalties if it is ultimately determined they are offering an illegal game, and an adverse regulatory or judicial determination regarding the legal status of our products could have material adverse consequences for our business, operating results and prospects.

The market for electronic Class II player terminals and systems, from which we derive the substantial majority of our revenue, is subject to continuing ambiguity due to the difficulty of reconciling the Johnson Act’s broad definition of “gambling devices” with the provisions of IGRA that expressly make legal the play of bingo and tribes’ use of “electronic, computer, or other technological aids” in the play of bingo. Issues surrounding the classification of our games as Class II games that may generally be offered by our tribal customers without a state compact, or as Class III games that can only be offered by the tribes pursuant to such a compact, have affected our business in the past, and continue to do so. Government enforcement, regulatory action, judicial decisions, or the prospects or rumors thereof have in the past and will continue to affect our business, operating results and prospects. Although some of our games have been reviewed and approved as legal, Class II, games by the NIGC, we have placed and continue to derive revenue from a significant number of player terminals that have not been so approved. Our business and operating results would likely be adversely affected, at least in the short term, by any significant regulatory enforcement action involving our games. The trading price of our common stock has in the past and may in the future be subject to significant fluctuations based upon market perceptions of the legal status of our products.

In addition to federal regulation, all Native American tribes are required by IGRA to adopt ordinances regulating gaming as a condition of their right to conduct gaming on Native American lands. These ordinances often include the establishment of tribal gaming commissions that make their own judgment about whether an activity is Class II or Class III gaming. It is our policy not to introduce a new game in a customer’s gaming facility unless the tribe’s gaming commission has made its own independent determination that the game is Class II gaming. Adverse regulatory decisions by tribal gaming commissions could adversely affect our business.

We also face risks from a lack of regulatory or judicial enforcement action. In particular, we believe we have lost market share to competitors who offer games that do not appear to comply with published regulatory restrictions on Class II games, and thereby offer faster play than, or features not available in our products. To the extent enforcement agencies such as the DOJ or NIGC permit tribes to offer these games, rather than ours, our market share, revenue and operating results may suffer.

It is possible that new laws and regulations relating to our business may be enacted, and that existing laws and regulations could be amended or reinterpreted in a manner adverse to our business. Any regulatory change could materially and adversely affect the installation and use of existing and additional player terminals, games and systems, and our ability to generate revenues from some or all of our Class II games.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

In addition to the risks described above, regulatory uncertainty increases our cost of doing business. We dedicate significant time and incur significant expense on new game development without any assurance that the NIGC, the DOJ or other federal, state or local agencies or Native American gaming commissions will agree that our games meet applicable regulatory requirements. We also devote significant time and expense to dealing with federal, state and Native American agencies having jurisdiction over Native American gaming, and in complying with the various regulatory regimes that govern our business. In addition, we are constantly monitoring new and proposed laws and

-30-

Table of Contents

regulations, or changes to such laws and regulations, and in assessing the possible impact upon us, our customers and our markets.

Our future performance will depend on our ability to develop and introduce new games and enhancements to existing games that are widely accepted and played.

Our historical revenue growth has been driven primarily by technological innovations to our gaming systems, and the increased size and use of our installed base of player terminals in the Class II market. Our future performance will depend primarily on our ability to successfully and cost-effectively enter new gaming markets and develop and introduce new and enhanced game content and systems that will be widely accepted both by our tribal customers and their end users. We believe our business requires us to continually offer games and technology that offer faster and more entertaining play than those our competitors offer. However, consumer preferences can be difficult to predict, and we may offer new games or technologies that do not achieve market acceptance. In addition, we may experience future delays in game development, or we may not be successful in developing, introducing, and marketing new games or game enhancements on a timely and cost-effective basis. Furthermore, our new games may be subject to challenge by the NIGC, the DOJ, or some other regulatory or law enforcement agencies applicable to that particular game.

If we are unable, for technological, marketing or other reasons, to develop and introduce new games or enhancements of existing products in a timely manner in response to changing regulatory, legal or market conditions or customer requirements, or if new products or new versions of existing products do not achieve market acceptance, or if uneven enforcement policies cause us to continue facing competition from non-compliant games offered by some competitors, our business could be materially and adversely affected.

We are dependent upon a few customers who are based in Oklahoma.

For the nine months ended June 30, 2004, two tribes in Oklahoma accounted for approximately 34% and 12% of our net gaming revenues. Approximately 69% of our net gaming revenues for the nine months ended June 30, 2004 were from Native American tribes located in Oklahoma. The significant concentration of our customers in Oklahoma means that local economic changes may adversely affect our customers, and therefore our business, disproportionately to changes in national economic conditions, including more sudden adverse economic declines or slower economic recovery from prior declines. The loss of any of our Oklahoma tribes as customers would have a material and adverse effect upon our financial condition and results of operations. In addition, the pending legislation allowing tribal-state compacts in Oklahoma could result in increased competition from other vendors, who we believe have avoided entry into the Class II market due to its uncertain and ambiguous legal environment. The new legislation allows for other types of gaming, both at tribal gaming facilities and at Oklahoma's racetracks. The loss of significant market share to these new gaming opportunities or our competitors' products in Oklahoma could also have a material adverse effect upon our financial condition and results of operations.

If states enter into compacts with our existing Native American customers to allow Class III gaming, our results of operations could be materially harmed.

The majority of our revenue is generated from the placement of Class II gaming systems with tribal customers who are not parties to any state compact that would permit them to offer Class III games. If any of our Class II tribal customers were to enter compacts with the states in which they operate, allowing the tribes to offer Class III games, we believe the number of game machine placements by us in those customers' facilities would decline significantly, and our operating results would be materially adversely affected.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

In February 2004, legislation authorizing certain forms of gaming at racetracks and additional types of games at tribal gaming facilities in the state, or the Bill, was approved in Oklahoma. The Bill was originally scheduled to become effective 90 days after the end of the current legislative session, which expired at the end of May 2004. However, in May 2004, the Bill was repealed by the Oklahoma Legislature and substitute legislation was passed by both the Oklahoma Senate and House that requires a statewide referendum in November 2004. Certain groups opposed to the legislation have vowed both to fight the new bills and to attempt to delay enactment of the new legislation. As a result, we are unable to determine when or if any new legislation authorizing certain forms of gaming at Oklahoma racetracks and additional types of games at tribal gaming facilities will become effective.

The majority of our revenue is generated from the placement of Class II gaming systems with tribal customers who are not currently parties to any state compact that would permit them to offer Class III games. Although the proposed Oklahoma compact specifically excludes slot machines, the new legislation will permit tribes in

Table of Contents

Oklahoma who enter into a compact with the state to offer games other than the Class II games we have historically offered in that state, including video poker and certain table games. Although we believe the new legislation will enable us to offer a broader range of games to our tribal customers in Oklahoma, we also expect the new legislation will bring intensified competition into the Oklahoma market, including new competition from credible gaming industry participants that to date have only had a limited presence in that market. In addition, we are experiencing an extended period of uncertainty relative to enforcement of existing restrictions on non-Class II devices, which is forcing us to continue to compete against games that do not appear to comply with published regulatory restrictions on Class II games. As a result of this increased competition in Oklahoma, we have and may continue to experience pressure on our pricing model. New opportunities in the Oklahoma market resulting from the recent legislation may not develop as we anticipate, or may take longer to develop than we expected. Further, we may offer games similar to those games that do not appear to comply with published regulatory restrictions on Class II games in an effort to compete on an equal footing. These games may be the subject of enforcement actions against us.

We believe the establishment of a state compact depends on a number of political, social, and economic factors which are inherently difficult to ascertain. Accordingly, although we attempt to closely monitor state legislative developments that could affect our business, we may not be able to timely predict when or if a compact could be entered into by one or more of our tribal customers. Moreover, our business requires that we provide support for the economic interests of our tribal customers, and we may therefore be restricted from taking political action or positions in opposition to the adoption of a compact.

We are seeking to expand our business by loaning money to new and existing Native American customers to develop or expand gaming facilities, and we are jointly developing or expanding gaming and related facilities with some of these customers. We have limited experience with these activities and may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.

To date, we have entered into development agreements to jointly develop and provide financing to construct and or remodel eleven tribal gaming facilities. Under our development agreements, we secure a long-term revenue share percentage and a guaranteed percentage of the tribal gaming facilities available floor space in exchange for development and construction funding. Certain of the agreements contain performance standards for our player terminals that could allow the facility to reduce a portion of our guaranteed floor space. In connection with these advances, we could face liquidity pressure or a complete loss of our investment if a tribe does not timely pay any amounts owed to us from such funding. In addition, future NIGC decisions could affect our ability to place our games with these tribes. See Certain Risk Factors Enforcement of remedies or contracts against Native American tribes could be difficult. In addition, the NIGC has recently expressed its view that our development agreement related to the WinStar Casino in Thackerville, Oklahoma, is a management contract subject to NIGC regulation, which presents additional risks for our business. See Certain Risk Factors Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

We may continue to seek to enter into strategic relationships and provide financing and development services for new or expanded gaming and related facilities for our customers. However, we may not realize the anticipated benefits of any strategic relationship or financing. In connection with one or more of these transactions, and to obtain the necessary development funds, we may issue additional equity securities which would dilute existing stockholders, extend secured and unsecured credit to potential or existing tribal customers which may not be repaid, incur debt on terms unfavorable to us or that we are unable to repay, and incur contingent liabilities.

We have limited experience in these types of activities. Our development effort or financing activities may result in unforeseen operating difficulties, financial risks or required expenditures that could adversely affect our liquidity. It may also divert the time and attention of our management that would otherwise be available for ongoing development of our business. As a result of providing financing or development services to our customers, we may incur liquidity pressure and we may not realize a satisfactory return, if any, on our investment, and we could lose some or all of our investment.

We believe diversification from Native American gaming activities is critical to our growth strategy. Our expansion into non-Native American gaming activities will present new challenges and risks that could adversely affect our business or results of operations.

Our growth strategy includes selling our games and technology into segments of the gaming industry other than Native American gaming, principally the charity and commercial bingo markets and new jurisdictions authorizing video lottery systems. These and other non-Native American gaming opportunities are not currently subject to a

Table of Contents

nationwide regulatory system such as the one created by IGRA to regulate Native American gaming, so regulation is on a state-by-state, and sometimes a county-by-county basis. In addition, federal laws relating to gaming, such as the Johnson Act, which regulates slot machines and similar gambling devices, would also apply to new video lottery jurisdictions, absent authorized state law exemptions.

As we expand into new markets, we would expect to encounter business, legal and regulatory uncertainties similar to those we face in our Native American gaming business. Successful growth in accordance with this strategy may require us to make certain changes to our gaming systems to ensure that they comply with applicable regulatory regimes, and may require us to obtain additional licenses. Importantly, in certain jurisdictions and for certain venues, our ability to enter these markets will depend on effecting changes to existing laws and regulatory regimes. The ability to effect these changes is subject to a great degree of uncertainty and may never be achieved. We may not be successful in entering into other segments of the gaming industry.

Generally, our selling of games and technology into new market segments involves a number of uncertainties, including:

Whether our resources and expertise will enable us to effectively operate and grow in such new markets;

Whether our internal processes and controls will continue to function effectively within these new segments;

Whether we have enough experience to accurately predict revenues and expenses in these new segments; and

Whether the diversion of management attention and resources from our traditional business, caused by entering into new market segments, will have harmful effects on our traditional business.

We believe transactions with existing and future customers may be more complex than transactions entered into currently. As a result, we may enter into more complicated business and contractual relationships with customers which, in turn, can engender increased complexity in the related financial accounting. As a result, the timing of actual revenue recognition may differ from our forecast.

If we are unable to effectively develop and operate within these segments, then entering into these new segments could have a material adverse effect on our business, operating results and financial condition.

If we are unsuccessful in our attempt to diversify to new lines of business, or if a specific project such as the New York Lottery racino project generates significantly less revenue than anticipated, our ability to grow and diversify our revenue streams may be impaired.

We compete for customers and end users with other vendors of gaming systems and player terminals. We also compete for end users with other forms of entertainment.

We compete with other vendors for customers, primarily on the basis of the amount of profit our gaming products generate for our customers in relation to other vendors' gaming products. We believe that the most important factor influencing our customers' product selection is the appeal of those products to end users. This appeal has a direct effect on the volume of play by end users, and drives the amount of revenues generated for

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

and by our customers. Our ability to remain competitive depends primarily on our ability to continuously develop new game themes and systems that appeal to end users, and to introduce those game themes and systems in a timely manner. See Certain Risk Factors. Our future performance will depend on our ability to develop and introduce new games and enhancements to existing games that are widely accepted and played. We may not be able to continue to develop and introduce appealing new game themes and systems that meet the emerging requirements in a timely manner, or at all. In addition, others may independently develop games similar to our games, and competitors may introduce non-compliant games that unfairly compete in certain markets due to uneven regulatory enforcement policies.

We believe continued developments in the Class II market that alleviate or clarify the legal and regulatory uncertainties of that market will result in increased competition in the interactive electronic Class II gaming market,

Table of Contents

including the entrance of new competitors with significant gaming experience and financial resources. Specifically, three of the largest manufacturers of gaming equipment have expressed an interest in the Class II market. We believe the increased competition will intensify pressure on our pricing model. In the future, gaming providers will compete on the basis of price as well as the entertainment value and technological superiority of their products. While we will continue to compete by regularly introducing new and faster games, with technological enhancements that we believe will appeal to end users, we believe that the net revenue our customers retain from their installed base of player terminals will become a more significant factor, one that may require us to change the terms of our participation arrangements with customers to remain competitive. Consequently, we believe that a simple business model based upon a relationship between the average hold per player terminal per day and the installed base of player terminals will become less relevant in predicting our performance, as the totality and the mix of our participation arrangements with customers become less standardized and more complex.

Given the limitations placed on Class II gaming, we may not be able to successfully compete in gaming jurisdictions and facilities where slot machines, table games and other forms of Class III gaming are permitted. Furthermore, increases in the popularity of and competition from an expansion of Class III gaming, or Internet and other account wagering gaming services, which allow end users to wager on a wide variety of sporting events and to play traditional casino games from home, could have a material adverse effect on our business, financial condition and operating results.

Our business requires us to obtain and maintain various licenses, permits and approvals from state governments and other entities that regulate our business.

We have obtained all state licenses, lottery board licenses, Native American gaming commission licenses, findings of suitability, registrations, permits and approvals necessary for the operation of our gaming activities. These include a license from Washington State to sell Class III video lottery systems, and licenses from the lottery boards of Texas, Louisiana, Mississippi, New York and the District of Columbia. The Louisiana Department of Revenue as well as the Mississippi Gaming Commission have also issued licenses to us and licenses from all applicable Native American gaming commissions. We may require new licenses, permits and approvals in the future, and such licenses, permits or approvals may not be granted to us. The suspension, revocation, non-renewal or limitation of any of our licenses would have a material adverse effect on our business, financial condition and results of operations.

We may not be successful in protecting our intellectual property rights, or avoiding claims that we are infringing upon the intellectual property rights of others.

We rely upon patent, copyright, trademark and trade secret laws, license agreements and employee nondisclosure agreements to protect our proprietary rights and technology, but these laws and contractual provisions provide only limited protection. We rely to a greater extent upon proprietary know-how and continuing technological innovation to maintain our competitive position. Insofar as we rely on trade secrets, unpatented know-how and innovation, others may be able to independently develop similar technology or our secrecy could be breached. The issuance of a patent to us does not necessarily mean that our technology does not infringe upon the intellectual property rights of others. As the Class II market grows and we enter into new markets by leveraging our existing technology, it becomes more and more likely that we will become subject to infringement claims from other parties. Problems with patents or other rights could increase the cost of our products, or delay or preclude new product development and commercialization. If infringement claims against us are valid, we may seek licenses that might not be available to us on acceptable terms or at all. Litigation would be costly and time consuming, but may become necessary to protect our proprietary rights or to defend against infringement claims. We could incur substantial costs and diversion of management resources in the defense of any claims relating to the proprietary rights of others or in asserting claims against others.

We rely on software licensed from third parties, and technology provided by third-party vendors, the loss of which could increase our costs and delay deployment of our gaming systems and player terminals. We also rely on technology provided by third-party vendors

which, if disrupted, could suspend play on some of our player terminals.

We integrate various third-party software products as components of our software. Our business would be disrupted if this software, or functional equivalents of this software, were either no longer available to us or no longer offered to us on commercially reasonable terms. In either case, we would be required to either redesign our software to function with alternate third-party software or develop these components ourselves, which would result in increased

Table of Contents

costs and could result in delays in our deployment of our gaming systems and player terminals. Furthermore, we might be forced to limit the features available in our current or future software offerings.

We also rely on the technology of third-party vendors, such as telecommunication providers, to operate our nationwide, broadband telecommunications network. A serious or sustained disruption of the provision of these services could result in some of our player terminals being non-operational for the duration of the disruption, which would adversely affect our ability to generate revenue from those player terminals.

We do not rely upon the term of our customer contracts to retain the business of our customers.

Our contracts with our customers are on a year-to-year or multi-year basis. Except for customers with whom we have entered into development agreements, we do not rely upon the stated term of our customer contracts to retain the business of our customers, as often non-contractual considerations unique to doing business in the Native American market override strict adherence to contractual provisions. We rely instead upon providing competitively superior player terminals, games and systems to give our customers the incentive to continue doing business with us. At any point in time, a significant portion of our business is subject to non-renewal, and, if not renewed, would materially and adversely affect our earnings and financial condition.

Changes in regulation or regulatory interpretations could require us to modify the terms of our contracts with customers.

Except as described below, the NIGC has considered the provisions of the agreements under which we provide our Class II games, equipment and services to our Native American customers, and has determined that these agreements are service agreements and are not management contracts. Management contracts are subject to additional regulatory requirements and oversight, including pre-approval by the NIGC, that could result in delays in providing our products and services to customers, as well as divert customers to our competitors.

On April 23, 2004, we reported that the acting General Counsel of the NIGC had issued a letter to us and one of our tribal customers opining that our development agreement regarding the WinStar Casino in Thackerville, Oklahoma constitutes a management contract. The authority of the NIGC to review and approve gaming related contracts is limited to management contracts and related collateral agreements. According to the acting General Counsel, the performance of any planning, organizing, directing, coordinating or controlling with respect to any part of a gaming operation constitutes management for purposes of determining whether an agreement for any of these activities is a management contract. We have expressed our disagreement with the acting General Counsel's interpretation, and our belief that her view of management is broader than was intended by Congress. We also believe that the acting General Counsel's opinion may be based in part on collateral agreements that we provided to the NIGC in error and that are not presently in effect. We, along with certain tribal customers, have submitted additional information and documents related to the development agreements for review by the NIGC. If certain of our development agreements are finally determined to be management contracts, there could be material adverse consequences to us. In that event, we may be required to modify the terms of such agreements. Such modification may adversely affect the terms on which we conduct business and significantly impact our financial condition and results of operations from this agreement and from other development agreements that may be similarly interpreted by the NIGC.

Our contracts could be subject to further review at any time. Any further review of these agreements by the NIGC could require substantial modification to our agreements, or result in their redesignation as management contracts, either of which could materially and adversely affect the terms on which we conduct our business.

If our key personnel leave us, our business could be materially adversely affected.

We depend on the continued performance of the members of our senior management team and our technology team. If we were to lose the services of any of our senior officers, directors, or any member of our technology team, and could not find suitable replacements for such persons in a timely manner, it could have a material adverse effect on our business.

Enforcement of remedies or contracts against Native American tribes could be difficult.

Governing and Native American Law. Federally recognized Native American tribes are independent governments, subordinate to the United States, with sovereign powers, except as those powers may have been limited by treaty or by the United States Congress. Native Americans power to enact their own laws to regulate gaming is an exercise of Native American sovereignty, as recognized by IGRA. Native American tribes maintain their own governmental

Table of Contents

systems and often their own judicial systems. Native American tribes have the right to tax persons and enterprises conducting business on Native American lands, and also have the right to require licenses and to impose other forms of regulation and regulatory fees on persons and businesses operating on their lands.

Native American tribes, as sovereign nations, are generally subject only to federal regulation. Although Congress may regulate Native American tribes, states do not have the authority to regulate Native American tribes unless such authority has been specifically granted by Congress. In the absence of a specific grant of authority by Congress, states may regulate activities taking place on Native American lands only if the tribe has a specific agreement or compact with the state. In the absence of a conflicting federal or properly authorized state law, Native American law governs.

Our contracts with Native American customers provide that the law of the state in which a tribe is located will be the governing law of those contracts. However, these choice-of-law clauses may not be enforceable.

Sovereign Immunity; Applicable Courts. Native American tribes generally enjoy sovereign immunity from suit similar to that of the individual states and the United States. In order to sue a Native American tribe (or an agency or instrumentality of a Native American tribe), the tribe must have effectively waived its sovereign immunity with respect to the matter in dispute.

Our contracts with Native American customers include a limited waiver of each tribe's sovereign immunity and generally provide that any dispute regarding interpretation, performance or enforcement shall be submitted to, and resolved by, arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association, and that any award, determination, order or relief resulting from such arbitration is binding and may be entered in any court having jurisdiction. In the event that such waiver of sovereign immunity is held to be ineffective, we could be precluded from judicially enforcing any rights or remedies against a tribe. These rights and remedies include, but are not limited to, our right to enter Native American lands to retrieve our property in the event of a breach of contract by the tribe party to that contract.

If a Native American tribe has effectively waived its sovereign immunity, there exists an issue as to the forum in which a lawsuit can be brought against the tribe. Federal courts are courts of limited jurisdiction and generally do not have jurisdiction to hear civil cases relating to Native Americans. In addition, contractual provisions that purport to grant jurisdiction to a federal court are not effective. Federal courts may have jurisdiction if a federal question is raised by the suit, which is unlikely in a typical contract dispute. Diversity of citizenship, another common basis for federal court jurisdiction, is not generally present in a suit against a tribe, because a Native American tribe is not considered a citizen of any state. Accordingly, in most commercial disputes with tribes, the jurisdiction of the federal courts may be difficult or impossible to obtain. We may be unable to enforce any arbitration decision effectively.

We may incur prize payouts in excess of game revenues.

Certain of our contracts with our Native American customers relating to our Legacy system games provide that our customers receive, on a daily basis, an agreed percentage of gross gaming revenues based upon an assumed level of prize payouts, rather than the actual level of prize payouts. This can result in our paying our customers amounts greater than our customers' percentage share of the actual hold per day. In addition, because the prizes awarded in our games are based upon assumptions as to the number of players in each game and statistical assumptions as to the frequency of winners, we may experience on any day, or over short periods of time, a game deficit, where the total aggregate amount of prizes paid exceeds aggregate game revenues. If we have to make any excess payments to customers, or experience a game deficit over any statistically relevant period of time, we are contractually entitled to adjust the rates of prize payout to end users in order to recover any deficit. In the future, we may miscalculate our statistical assumptions or, for other reasons, we may experience abnormally high rates of jackpot prize wins which

could materially and adversely affect our cash flow on a temporary or long-term basis, and which could materially and adversely affect our earnings and financial condition.

Our business prospects and future success rely heavily upon the integrity of our employees and executives and the security of our gaming systems.

The integrity and security of our gaming systems is critical to its ability to attract customers and players. We strive to set exacting standards of personal integrity for our employees and system security for the gaming systems that we provide to our customers. Our reputation in this regard is an important factor in our business dealings with our

Table of Contents

current and potential customers. For this reason, an allegation or a finding of improper conduct on our part of one or more of our employees that is attributable to us, or an actual or alleged system security defect or failure attributable to us, could have a material adverse effect upon our business, financial condition, results and prospects, including our ability to retain existing contracts or obtain new or renewal contracts.

Any disruption in our network or telecommunications services, or adverse weather conditions in the areas in which we operate could affect our ability to operate our games, which would result in reduced revenues and customer down time.

Our network is susceptible to outages due to fire, floods, power loss, break-ins, cyberattacks and similar events. We have multiple site back-up for our services in the event of any such occurrence. Despite our implementation of network security measures, our servers are vulnerable to computer viruses and break-ins; similar disruptions from unauthorized tampering with our computer systems in any such event could have a material adverse effect on our business, operating results and financial condition.

Adverse weather conditions, particularly flooding, tornadoes, heavy snowfall and other extreme weather conditions often deter our end users from traveling or make it difficult for them to frequent the sites where our games are installed. If any of the those sites were to experience prolonged adverse weather conditions, or if the sites in Oklahoma where a significant number of our games are installed were to simultaneously experience adverse weather conditions, our results of operations and financial condition would be materially adversely affected.

In addition, our agreement with the New York State Division of the Lottery permits termination of the contract at any time for failure by us or our system to perform properly. We were also required to post a performance bond to secure our performance under such contract. Failure to perform under this or similar contracts could result in substantial monetary damages, as well as contract termination.

Worsening economic conditions may adversely affect our business.

The demand for entertainment and leisure activities tends to be highly sensitive to consumers' disposable incomes, and thus a decline in general economic conditions may lead to our end users' having less discretionary income with which to wager. This could cause a reduction in our revenues and have a material adverse effect on our operating results.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to market risks in the ordinary course of business, primarily associated with interest rate fluctuations.

In June 2003, we entered into a credit facility to provide us with additional liquidity to meet our short-term financing needs, as further described under PART I Item 1. Financial Statements Significant Accounting Policies Credit Facility, Long-term Debt and Capital Leases. Pursuant to the credit facility, we may borrow up to a total of \$25 million under a \$20 million term loan and a \$5 million revolving line of credit. The entire credit facility bears an adjustable interest rate of Prime plus 1.25% with a floor of 5.5%.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

In connection with the joint development agreements we enter into with many of our Native American tribal customers, we are required to advance funds to the tribes for the construction and development of tribal gaming facilities, some of which are required to be repaid. It is anticipated that some of these receivables will have fixed interest rates.

As a result of our adjustable interest rate notes payable and fixed interest rate notes receivable described above, we are subject to market risk with respect to interest rate fluctuations. Any material increase in prevailing interest rates could cause us to incur significantly higher interest expense, without a corresponding increase in interest income.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure

Table of Contents

controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. As of the end of the period covered by this report, and under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of these disclosure controls and procedures. Based on this evaluation and subject to the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in reaching a reasonable level of assurance of achieving management's desired controls and procedures objectives.

There have been no changes in our internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

As part of a continuing effort to improve our business processes we are evaluating our internal controls and may update certain controls to accommodate any modifications to our business processes or accounting procedures.

Table of Contents

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are subject to litigation from time to time in the ordinary course of our business, as well as litigation to which we are not a party that may establish laws that affect our business. See PART I Item 1. Financial Statements Commitments and Contingencies.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

See Exhibit Index.

(b) Reports on Form 8-K

During the quarter ended June 30, 2004, we filed the following reports on Form 8-K:

<u>Date 8-K Filed</u>	<u>Item(s) Reported</u>
April 1, 2004	Item 9
May 3, 2004	Items 7 and 12

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 16, 2004

Multimedia Games, Inc.

By: /s/ **CRAIG S. NOUIS**
Craig S. Nouis

Chief Financial Officer

Mr. Nouis is signing as an authorized officer and as our principal financial officer and chief accounting officer.

-40-

Table of Contents**EXHIBIT INDEX**

EXHIBIT NO.	TITLE	LOCATION
3.1	Amended and Restated Articles of Incorporation	(1)
3.2	Amendment to Articles of Incorporation	(10)
3.3	Amended and Restated Bylaws	(2)
10.1	Form of Integrated Gaming Services Agreement	(3)
10.2	1994 Employee Stock Option Plan	(3)
10.3	1994 Director Stock Option Plan	(3)
10.4	1996 Stock Incentive Plan, as amended	(4)
10.5	1998 President's Plan	(5)
10.6	1998 Senior Executive Stock Option Plan	(5)
10.7	2000 Stock Option Plan	(5)
10.8	2001 Stock Option Plan	(6)
10.9	Stockholder Rights Plan	(7)
10.9	2002 Stock Option Plan	(8)
10.10	Employment Agreement executed March 26, 2003 between the Company and Gordon Graves	(8)
10.11	2003 Outside Directors Stock Option Plan	(9)
10.12	Loan and Security Agreement between the Company and Comerica Bank	(10)
10.13	First Amendment to Loan and Security Agreement between the Company and Comerica Bank	(10)
31.1	Certification of Principal Executive Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002	(*)
31.2	Certification of Principal Financial Officer, pursuant to Section 302 of the Sarbanes Oxley Act of 2002	(*)
32.1	Certification Pursuant to U.S.C. Section 1350, as adopted, pursuant to Section 906 of the Sarbanes Oxley Act of 2002	(*)

(1) Indicates incorporated by reference to our Form 10-QSB filed with the Commission for the quarter ended March 31, 1997.

(2) Indicates incorporated by reference to our Form 10-K filed with the Commission for the fiscal year ended September 30, 2003.

(3) Indicates incorporated by reference to our Form 10-KSB filed with the Commission for the fiscal year ended September 30, 1994.

(4) Indicates incorporated by reference to our Form 10-KSB filed with the Commission for the fiscal year ended September 30, 1996.

(5) Incorporated by reference to our Registration Statement on Form S-8 filed with the Commission on December 1, 2000.

Edgar Filing: MULTIMEDIA GAMES INC - Form 10-Q

- (6) Incorporated by reference to our Registration Statement on Form S-8 filed with the Commission on October 18, 2002 (File No. 333-100611.)
- (7) Incorporated by reference to our Registration Statement on Form 8-A, filed with the Commission on October 23, 1998.
- (8) Incorporated by reference to our Form 10-Q filed with the Commission for the quarter ended March 31, 2003.
- (9) Incorporated by reference to Appendix B of our Definitive Proxy Statement on Schedule 14A filed with the Commission on January 6, 2004.
- (10) Incorporated by reference to our Form 10-Q filed with the Commission for the quarter ended December 31, 2003.
- (*) Filed herewith.