
**MARYLAND LOTTERY and
GAMING CONTROL COMMISSION**

1800 Washington Blvd., Suite 330, Baltimore, Maryland 21230

COMMISSION REPORT



Incredible Technologies, Inc.

MANUFACTURER LICENSE APPLICANT

Report Date: December 9, 2015

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Introduction

As a prerequisite to being eligible for a video lottery facility manufacturer license (“manufacturer license”), a manufacturer of a video lottery terminal (“VLT”), table game, or associated equipment must submit a Manufacturer License Application to the Maryland Lottery and Gaming Control Commission (“the Commission”). An applicant must prove to the Commission that it meets the qualification criteria set forth in the Annotated Code of Maryland, State Gov’t Article (“SG”), § 9-1A-01, *et seq.* (“the Gaming Law”). Specifically, an applicant for a manufacturer license must prove, by clear and convincing evidence, that it is qualified under SG § 9-1A-07(c)(7)(i) through (v), and not disqualified under SG § 9-1A-08(d). SG § 9-1A-15. An applicant must provide all information to the Commission that is necessary for a qualification determination as to the applicant, its principals, and its principal entities.

The Maryland Lottery and Gaming Control Agency (“MLGCA,” “we” or “our”), conducted a suitability background license investigation of Incredible Technologies, Inc. (“the Applicant” or “the Company”) in connection with its application for a manufacturer license submitted to the Commission.

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Background

The Applicant is an Illinois corporation originally formed in July 1985 under the name Free-Radical Software, Inc. The Company changed its name to “Incredible Technologies, Inc.” in January 1987. The Applicant designs, develops, and manufactures entertainment products for the industries of on-premise amusement, including coin-operated video games, and casino gaming which includes video slot, poker and keno content.

The Applicant is currently licensed by 14 state regulatory gaming authorities, approximately 67 tribal gaming commissions and agencies, and gaming authorities in three countries worldwide. Its corporate headquarters is located at 200 Corporate Woods Parkway, Vernon Hills, Illinois.

Incredible Technologies, Inc. is a privately held company owned by the Elaine A. Hodgson 2008 Special Trust (51%), and the Richard A. Ditton 2014 Special Trust (49%). The Elaine A. Hodgson 2008 Special Trust was formed on September 3, 2008 in the state of Illinois, and Elaine A. Hodgson is the sole trustee of this Trust. Similarly, the Richard A. Ditton 2014 Special Trust was formed on June 9, 2014 in the state of Illinois with Richard A. Ditton serving as the sole trustee of this Trust.

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The Elaine A. Hodgson 2008 Special Trust and Richard A. Ditton 2014 Special Trust have both submitted Principal Entity Applications to the Commission as Principal Entities of Incredible Technologies, Inc. Mrs. Elaine A. Hodgson and Mr. Richard A. Ditton are the primary beneficiaries of the respective Trusts, and both individuals have submitted principal employee applications to the Commission.

Discussion of Recent Financial Performance

We performed a detailed analysis of the Applicant's financial performance for the years ended December 31, 2014 and 2013. Note that the Applicant's consolidated financial statements include accounts of its variable interest entity "Incredible Holdings, LLC", which is affiliated through common management and ownership. Incredible Holdings, LLC was formed in 2012 and leases a building solely to the Applicant .

Revenue – Total revenue in 2014 was \$30.3 million, compared to \$29.3 million in 2013, a \$1.0 million, or 3.5%, increase. This increase resulted mainly from an increase in gaming division equipment and software sales of \$2.5 million, as well as an increase of approximately \$500,000 in participation and daily fee revenue. The increase in sales resulted mainly as the Company introduced a new gaming cabinet which produced \$2.4 million

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more in sales revenue in 2014 than the year prior. These increases were offset by a decline in equipment and parts sales in its coin operated amusement division of approximately \$1.5 million.

Cost of Revenue – The cost of goods sold (including development expenses) decreased modestly to \$19.5 million in 2014 from \$19.9 million in 2013. This decrease resulted from the aforementioned decrease in sales activity in its coin operated amusement division, and a decrease in costs for software development.

Operating Expenses – Operating expenses of \$8.2 million in calendar year 2014 were relatively unchanged from the previous year.

Operating & Net Income – Operating income increased by \$1.4 million, or 124%, from \$1.2 million in 2013 to \$2.6 million in 2014. Additionally, net income increased substantially from \$1.0 million in calendar 2013 to \$2.4 million in 2014. The increase in the operating and net profits resulted from the aforementioned increase in revenue and the decrease in costs overall, discussed previously.

Assets, Liabilities, and Shareholder Equity – Total assets increased by \$1.5 million, or 7.4%, to \$21.1 million as of December 31, 2014, from \$19.6 million as of December 31, 2013. The increase in total assets was due mainly

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to an increase in accounts receivable of \$1.4 million. Total liabilities increased approximately \$242,000 during the calendar year ended December 31, 2014 to \$5.7 million, a 4.4% increase from December 31, 2013.

This increase was primarily attributable to increases in current liabilities in the form of unearned revenue and accrued expenses. The Company's ability to increase its total assets while effectively managing its liabilities has provided growth to shareholder equity which increased from \$14.2 million as of December 31, 2013 to \$15.4 million as of December 31, 2014, an 8.6% increase.

Liquidity and Cash Flow

The Applicant has consistently generated positive cash flows from operating activities over the review period. The Company had cash and equivalents totaling \$1.5 million as of the year ended December 31, 2014 which increased by approximately \$676,000 from \$832,000 as of December 31, 2013. This increase resulted primarily from positive operating cash flows of \$2.4 million generated through its net profits, offset somewhat by increases in accounts receivable. Cash used in financing activities during 2014 increased approximately \$188,000 due to an increase in dividend payments,

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and cash used in investment activities decreased approximately \$84,000 due to a decrease in capital expenditures.

Over the calendar years, 2010 to 2014, cash generated from operating activities totaled approximately \$7.4 million and again was largely a result of the Company's ability to consistently generate profits. Net cash used in financing activities over the period was \$6.5 million and resulted mostly from the payment of dividends to stockholders and the repayment of long-term debt obligations. The Applicant reinvested its operating cash flows into its business in the form of acquisitions of property and equipment, and product development, all of which resulted in net cash used in investing activities of \$4.4 million since calendar year 2010.

Long-Term Debt

The Applicant's long-term debt decreased from \$3.0 million as of December 31, 2013 to \$2.7 million as of December 31, 2014, an 8.2% decrease. The debt consists solely of a variable-rate term note payable held by Chase Bank by the Company's related entity Incredible Holdings, LLC. The term note payable is collateralized by land and the building leased to the Applicant by Incredible Holdings. Additionally, the term note is guaranteed by the Applicant and requires monthly principal payments of \$20,306 plus

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interest at LIBOR (.15% at December 31, 2014) plus 2.0%. The term note matures in March 2019, and at the time a balloon payment of approximately \$2 million is due. Incredible Holdings is subject to certain restrictive covenants which it was not fully in compliance with as of December 31, 2014. However, Incredible Holdings obtained a written waiver to these covenants from the bank subsequent to December 31, 2014.

In addition to the note payable, the Applicant had available to it a \$2,000,000 revolving line of credit with Chase Bank. As of December 31, 2014 there were no outstanding borrowings against this line of credit. Interest on any outstanding borrowings is payable monthly at the prime rate or LIBOR plus 2.25%, at the Company's discretion at the time the funds are borrowed. The revolving line of credit is collateralized by substantially all of Incredible Technologies' assets.

Five-Year Review of Financial Operating Results

The Applicant is subject to risk resulting from rapid changes in the popularity of games and competition from other developers who operate in the coin-operated video game industry and the gaming industry. The Company is subject to a high degree of regulatory oversight, and changes in consumer interest and spending habits could adversely affect sales of its

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existing products. Nevertheless, the Company has experienced consistently favorable operating performance and does not appear to have been significantly adversely affected by these external conditions. To assist in our evaluation of the Applicant's financial performance and suitability, we performed a review of its operating results and related trend analyses over a five-year period. Additionally, we performed a comparative analysis of the Applicant's performance with five other companies that operate in its industry.

Revenues and Expenses

The Applicant's operating results were consistently positive but did show some declines in calendar years 2011 through 2013 which resulted from fluctuations in revenue growth and an increase in selling, general and administrative expenses. The Company realized operating profits each year which decreased from \$3.4 million in 2010 to \$2.6 million in 2014, a 22.5% decrease. This decrease was driven by increases in operating expenses from \$6.1 million in 2010 to \$8.2 million in 2014, a 33.0% increase. However, revenue increased from \$27.8 million in calendar year 2010 to \$30.3 million in 2014, a 9.1% increase. The Company's ability to grow its revenue has improved its operating margin significantly in fiscal year 2014 from the year prior.

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Additionally, its operating profits have benefited from the effective management of its costs of revenue which decreased slightly as a percentage of revenue from 65.8% in 2010 to 64.4% in 2014.

Balance Sheet

The Applicant's positive financial performance over the past five years is reflected in its balance sheet as well. Current assets increased marginally by approximately \$18,000 and consisted mainly of accounts receivable totaling \$7.9 million and inventory totaling \$3.9 million as of December 31, 2014. Non-current assets increased by 777.8% over the five-year period from \$838,000 as of December 31, 2010 to \$7.4 million as of December 31, 2014. This increase is mostly due to increases in land, buildings and improvements of \$5.7 million and leased gaming equipment of \$1.3 million. Total liabilities increased from \$2.9 million as of December 31, 2010 to \$5.7 million as of December 31, 2014, a 97.4% increase. The majority of this increase is due to an increase in long-term debt from zero as of December 31, 2010 to \$2.7 million as of December 31, 2014. This debt was incurred mainly to acquire the aforementioned land and buildings. Current liabilities as of December 31, 2014 amounted to approximately \$3.0

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million which represents a modest 2.9% increase over the entire period reviewed. The Company's growth in assets over time combined with effective management of liabilities has resulted in a substantial increase in shareholder equity of \$3.7 million, or 31.8% over the review period.

Trend Analysis and Comparative Performance

- **Current Ratio and Quick Ratio** - The Company's current ratio of 4.61 is very strong and has experienced only a slight decline over the five year review period. Similarly, the quick ratio of 3.31 is strong and has declined marginally. Despite the declines, these ratios still reflect the Company's ability to control short-term liabilities, and readily satisfy short-term debt. The current ratio exceeded that of four of the five competitors reviewed whose ratios ranged from 1.52 to 5.06, and the quick ratio exceeded that of four of the five competitors whose ratios ranged from 1.09 to 4.73.
- **Operating Profit Margin and Net Profit Margin** - The Company's operating profit margin of 8.60% in fiscal 2014 is good but has declined over the review period as the increase in operating expenses exceeded revenue growth. Similarly, its net profit margin of 8.01% is good but has also declined over the period. In spite of the declines, the

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Applicant's profit margins are positive and have improved in recent years as management effectively increased revenue while decreasing its costs overall. Its operating profit margin exceeded that of three of the five competitors reviewed whose ratios ranged from (9.67%) to 23.80%, and its net profit margin exceeded that of two of the competitors whose ratios ranged from (13.12%) to 36.78%.

- **Return on Equity and Return on Assets** - Return on equity of 15.78% was positive but has declined over the review period. This decline resulted as shareholder equity increased substantially through the purchase of property and equipment and the generation of net profits while its net profits experienced negative growth due to the aforementioned increase in operating expenses. Nevertheless, the return on equity ratio exceeded three of the five competitors whose ratios ranged from (6,007.69%) to 48.93%, and its return on assets ratio of 11.50% exceeded that of four of the five competitors whose ratios ranged from (2.34%) to 29.70%. Both the return on equity and return on assets indicate that the Applicant is reasonably efficient at using its equity and assets to generate profits.
- **Debt to Equity Ratio and Debt Ratio** - The Company's debt to equity ratio of 0.372 to 1 as of December 31, 2014 is strong but has decreased

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in strength from 0.248 to 1 as of December 31, 2010, which indicates a slightly stronger reliance on external lenders. The Company's debt to equity ratio was more favorable than four of the five competitors with ratios ranging from 2,561.872 to 1 to 0.289 to 1. Additionally, its debt ratio of 0.271 to 1 was more favorable than four of the five competitors with ratios ranging from 1.00 to 1 to 0.224 to 1. The Applicant's debt to equity ratio and debt ratio indicate that it is not overly burdened with debt and that it should not have difficulty meeting its short and long-term debt obligations given its consistently positive operating performance.

- **Inventory Turnover Ratio** – The Applicant's inventory turnover ratio in 2014 of 5.04 is good but has declined from 7.86 in 2010. This indicates a slight decline in the Company's ability to efficiently manage its inventory levels which could potentially lead to unnecessary inventory carrying costs. However, this ratio does not appear to be problematic as the Applicant's inventory turnover ratio exceeded that of four of the five competitors whose ratios ranged from 1.27 to 11.81.
- **Interest Coverage Ratio** - The Applicant's interest coverage ratio of 20.02 is very positive but has declined in strength over the period as the Company increased its debt level through long-term debt financing.

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Nonetheless, its ratio exceeded that of four of the five competitors whose ratios ranged from (0.56) to 55.82, and there is no indication that the Company is having any difficulty meeting its interest payments.

Independent Audit of Annual Financial Statements

The Applicant and its Affiliate's, Incredible Holdings, LLC, annual consolidated financial statements (Balance Sheets and Statements of Income, Stockholders' Equity, and Cash Flows) for the years ended December 31, 2010 through December 31, 2014 were audited by an independent accounting firm which annually issued unqualified opinions. In its latest opinion letter dated March 27, 2015, applicable to the financial statements for the calendar years ended December 31, 2014 and 2013, the firm concluded that the Company's consolidated financial statements present fairly, in all material respects, the financial position of the Applicant and its Affiliate as of the aforementioned dates, and the results of its operations and cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States.

Tax Returns

The Applicant annually files Form 1120S U.S. Income Tax Return for an S Corporation with the Internal Revenue Service. We compared the tax

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returns filed by the Company for the tax years 2010 through 2014, with the Applicant's audited financial statements and noted no material differences or any apparent anomalies. The notes to the audited financial statements for the years ended December 31, 2014 and 2013 indicate that the Applicant is subject to routine audits by taxing jurisdictions and that there are currently no audits for any tax periods in progress, and management believes the Company is no longer subject to income tax examinations prior to 2011. In addition, the Company noted that the tax years of 2011 and 2012 were audited by the State of Illinois which found no discrepancies.

As an S Corporation, the Company is not taxed on its profits. Rather, the profits and losses of the business flow through to the stockholder(s) in proportion to their respective ownership percentages. Each stockholder annually receives a Schedule K-1 (Form 1120S) which reflects that stockholder's share of the Company's ordinary business income, interest earnings, etc. to be included on the stockholder's individual tax return. We reviewed the Schedule K-1 prepared for Incredible Technologies' stockholders for calendar years 2010 through 2014 and noted no anomalies.

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Dun & Bradstreet

We obtained a Dun & Bradstreet investigative report on the Applicant. The report indicates that it is generally prompt in paying its debts, noting only a small number of payments being made 2 days late. D&B assigned the Company a viability risk score of “2” on a scale of 1 (low risk) to 9 (high risk) and a financial stress score of “2” on a scale of 1 (lowest) to 5 (highest), indicating that there is little risk that the Company will go out of business or file for bankruptcy within the next twelve months. D&B reports a credit score of 592 for the Applicant on a scale of 101 to 670. The D&B report did not disclose any liens filed against the Company or any bankruptcies filed by the Applicant. The report did disclose an immaterial judgment against the Applicant in the amount of \$1,948. No derogatory information was disclosed in the D&B report.

Litigation

An internet search was conducted for any litigation records (bankruptcy, civil, and criminal) pertaining to the Applicant. The search disclosed one civil case with the Applicant as the plaintiff, related to copyright and trademark infringement alleged against the defendants. This

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case was dismissed with prejudice shortly after it was filed. No bankruptcy or criminal cases were noted.

In its Manufacturer License Application, the Applicant reported several civil cases which consisted mostly of product liability lawsuits where it was named as the defendant. The Company was able to reach settlement agreements with the plaintiffs in each of these cases. The settlements were covered by insurance and there was no materially adverse impact on the product offerings, operations, or financial position of Incredible Technologies, Inc.

Financial Analysis

The Applicant's overall financial performance during the period reviewed can be characterized as consistently positive. This is evidenced by the Company's ability to generate and increase its annual revenue, and to consistently generate positive operating cash flows and annual profits. Although expenses incurred to generate revenue increased substantially over the period, its revenues were at levels that enabled the Company to continue to generate profits during times of rising costs. This consistently strong operating performance has enabled Incredible Technologies to invest in product development and equipment, pay dividends to stockholders, and

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readily satisfy its debt demands. Additionally, Incredible Technologies improved its financial position over the period reviewed through substantial asset growth which significantly outpaced increases in liabilities. The Company is not highly leveraged and does have a substantial amount of borrowing capacity available to it should the need arise. There is no indication that the Applicant is experiencing any financial distress, and the Company's auditors have not expressed any concerns with the Company's financial condition. There are no areas of concern with the Applicant's financial suitability for licensure as a manufacturer, or with the Elaine A. Hodgson 2008 Special Trust and the Richard A. Ditton 2014 Special Trust as Principal Entities.

FINDINGS

The MLGCA conducted a complete and thorough background investigation as authorized under the Gaming Law by analyzing corporate records and documents, scrutinizing the business operations, practices, and transactions of Incredible Technologies, Inc. and the other qualifying entities, and conducting interviews of key personnel, focusing on required qualification criteria involving integrity and financial stability. MLGCA adhered to well-defined and approved investigative protocols in assembling

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the factual information incorporated in this report. The results of the investigation for the specific qualification criteria enunciated in SG §§ 9-1A-07(c)(7), 9-1A-08(d), and 9-1A-15 are summarized as follows:

1) Financial stability, integrity and responsibility

A comprehensive review was conducted of all of the consolidated financial statements for the last five years. The Applicant satisfies the standards for financial stability, integrity and responsibility. MLGCA also concludes that all of the individual qualifiers (principals) satisfy the Gaming Law's qualification criteria in connection with the Manufacturer License Application.

2) Integrity of financial backers, investors, mortgages, bondholders, and other holders of indebtedness

Based on our review, there are no material issues involving the known financial backers of the Applicant.

3) Good character, honesty, and integrity

MLGCA found that the Applicant possesses the requisite good character, honesty and integrity. No significant issues surfaced concerning the qualifications of the Applicant or its individual qualifiers. There were no

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material issues discovered pertaining to Incredible Technologies, Inc.'s record of regulatory compliance or litigation matters.

4) Sufficient business ability and experience

The Applicant has established itself as a leading provider of electronic gaming equipment and clearly possesses the requisite business ability and experience.

5) Potential Disqualifying factors

The Applicant is not disqualified from being issued a manufacturer license based on any of the criteria listed in SG § 9-1A-08(d). The Applicant is qualified to be awarded a license by the Commission.

APPLICANT and PRINCIPAL ENTITIES

The applicant, Incredible Technologies, Inc. and its principal entities satisfy the applicable qualification criteria under SG § 9-1A-07(c)(7), and are not disqualified under SG § 9-1A-08(d).

PRINCIPAL QUALIFIERS

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We identified the following natural person qualifiers (“principals”) who are associated with the Applicant and its principal entities. We conducted an extensive due diligence investigation on each qualifier, as described in our full report. We found that these principals have satisfied the applicable qualification criteria under SG § 9-1A-07(c)(7), and that none are disqualified under SG § 9-1A-08(d).

1. Elaine A. Hodgson – President / Chief Executive Officer
2. Richard A. Ditton – Executive Vice President
3. James M. Dore – Chief Financial Officer / Chief Operating Officer

CONCLUSIONS and OPINION

MLGCA’s investigation has confirmed that the Applicant has sufficient financial resources and found no derogatory information regarding the Applicant’s qualifications. Based on the criteria in SG §§ 9-1A-07(c)(7) and 9-1A-08(d), we conclude that the Applicant, its principal entities, and principals, have established by clear and convincing evidence their qualifications for a manufacturer license.