

Project Lonestar

Discussion Materials

January 2007

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SECTION 1

The Investment Case

SWOT Analysis of the Texas Lottery

The Texas Lottery has an attractive investment case

Strengths

- ◆ Monopolistic position
- ◆ Stable, defensive cashflows
- ◆ Relatively high operating margins
- ◆ Low risk business model (unlike casinos and betting)
- ◆ Good social responsibility track record

Opportunities

- ◆ Potential to introduce new games and products
- ◆ Technological innovation
- ◆ Optimize payout ratio, increase stakes and frequency of draws
- ◆ Increase penetration rates through more effective marketing
- ◆ Strong catch-up potential in lottery sales per capita (\$166 vs. \$251 for US average)
- ◆ Private sector incentives to improve sales and margins

Weaknesses

- ◆ Relatively mature industry
 - organic growth only
- ◆ Public sector obligations restrict operational flexibility
- ◆ Profit maximization not the sole objective, need to consider social aspects
- ◆ Need to continually innovate and generate new games to maintain public interest

Threats

- ◆ Regulatory, tax and political uncertainty
- ◆ Cannibalization from other gaming products (intrastate, neighboring states, online)
- ◆ Future threat of US online gaming legalization

Potential Growth Areas

Numerous opportunities to grow lottery income

1 Introduce New Lottery Products

- ◆ Potential new games include, Powerball, Hot Lotto, Spiel, Keno and VLTs
- ◆ Need to assess social and policy impact of introducing new games

2 Increase Stakes/Frequency of Draws

- ◆ Offer higher stakes games
 - over 40% of US lotteries offer instant games between \$12–30
 - Texas has mixture of instant games costing \$10 or less and offers four \$20 games

3 Use Lottery Terminals for Ancillary Income

- ◆ Numerous successful precedents in Europe (Italy, UK)
- ◆ State to earn commission on ancillary services (e.g. bill/fine payments)

4 Optimize Payout Ratio

- ◆ Critical to maximizing lottery proceeds
- ◆ Explore opportunities to increase/decrease payout ratio to increase revenue

5 Embrace New Technologies

- ◆ International lotteries are increasingly using the Internet and interactive digital TV to increase sales and reduce costs
- ◆ US restrictions with regards to using the Internet as a gaming medium

6 Other

- ◆ Texas Lottery profit margins (29%) are slightly below the national average of 31%
- ◆ Some potential benefits from private sector management

Potential Growth Areas

Potential New Lottery Products

	Instant	Pulltabs	3-digit	4-digit	Lotto	Powerball	Hot Lotto	Mega Millions	Cash Lotto	Spiel	Keno	Fast Keno	VLTs
Texas	✓		✓		✓			✓	✓				
% of states ¹ offering product	98	24	85	66	73	68	20	29	93	2	10	27	15

Source La Fleur's

Note

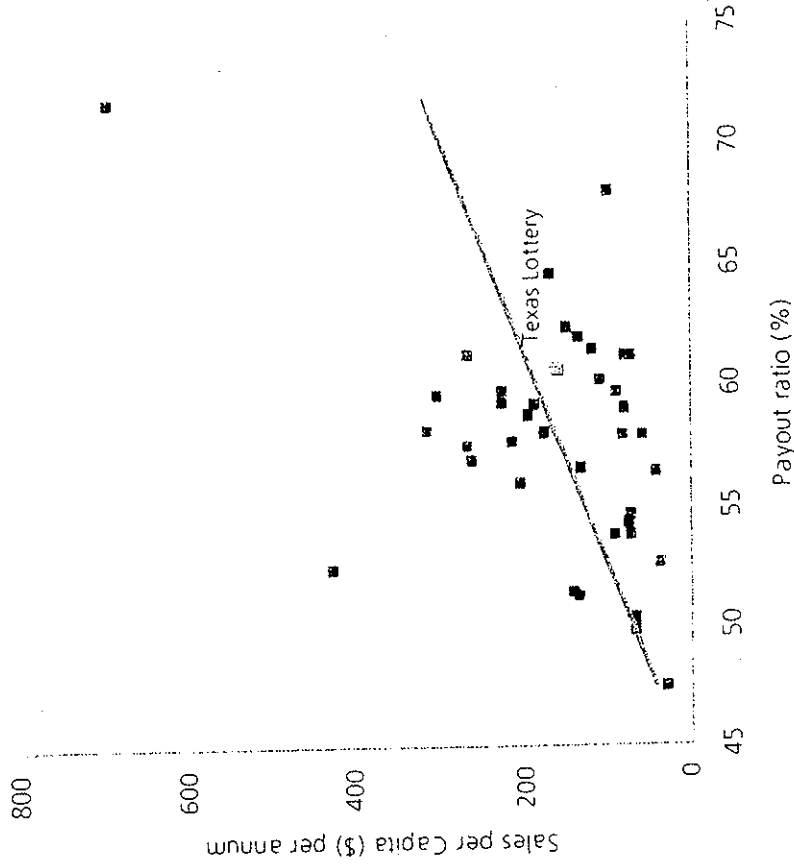
¹ Only states that offer lottery products are included (40 states plus Washington, D.C.)

Key Measures for the Texas Lottery

	Sales per Capita (\$)	Operating Profit Margin (%)
Texas	166	29.4
US Average	251	31.0
Texas Lottery	21 st	19 th

Source North American Association of State and Provincial Lotteries

Sales per Capita vs Prizes as % of Sales



Source

La Fleur's

SECTION 2

Preliminary Valuation Considerations

Valuation Methodologies

There are three key valuation methodologies for valuing gaming businesses

Trading Comparables

- ◆ Analyze valuation ratings of listed lottery companies
- ◆ Limited number of listed single jurisdiction lottery operators
 - OPAP (Greece) and Lottomatica (Italy) trade at approx 10.0x–10.5x EBITDA (2007E)
- ◆ Distorted by length of license term, market exclusivity, tax and regulatory environment, amongst other issues
- ◆ Usually used as a valuation cross check

Precedent Transactions

- ◆ Analyze prices paid for previous lotteries
- ◆ Very few privatized lotteries worldwide, thus limited M&A precedents
 - De Agostini's acquisition of Lottomatica only material precedent to date (5.6x EBITDA)
- ◆ Similar drawbacks to trading comparables analysis

DCF Analysis ("Discounted Cash Flow")

- ◆ Primary valuation methodology for lotteries
- ◆ Most common methodology used by equity research analysts
- ◆ Powerful tool to model and sensitize maturity, growth rates, etc.
- ◆ Highly dependent on underlying assumptions

DCF analysis is the most appropriate methodology for valuing lotteries

Trading Comparables Analysis

Limited number of listed lottery companies worldwide

Trading Comparables

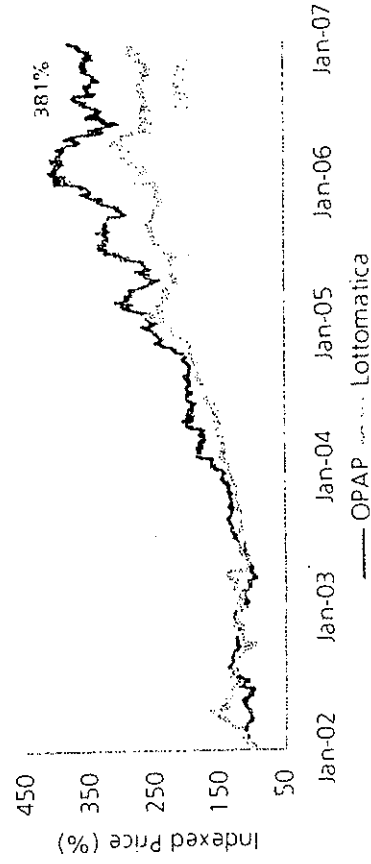
- The most relevant comparables are Lottomatica and OPAP
- OPAP is a Greek lottery operator which was listed on the Athens Stock Exchange following its privatization. OPAP is not a pure play lottery company as it also offers Stihima, a fixed odds betting game which generated 46.1% of OPAP's operating revenues for the three-month period ending March 31, 2006, up from 34.1% of operating revenues from the same period in 2005
- Lottomatica was listed on the Electronic Stock Market managed by Borsa Italiana in 2001. It represents one of the largest lotteries in the world and is the market leader in Italy
- Lottery operators such as Intralot and Scientific Games operate lotteries across many different jurisdictions so they are not direct comparables in this case

(US\$mm)	Market Cap	EV/EBITDA (x)			PE (x)		
		2006E	2007E	2008E	2006E	2007E	2008E
Lottomatica	4,822	12.0	10.5	9.3	27.0	26.4	24.4
OPAP	12,238	11.1	10.2	9.2	18.1	15.0	13.2
Intralot	2,078	8.5	7.7	7.0	18.9	17.1	16.2
Scientific Games	2,696	11.3	8.9	8.0	30.2	22.1	18.6

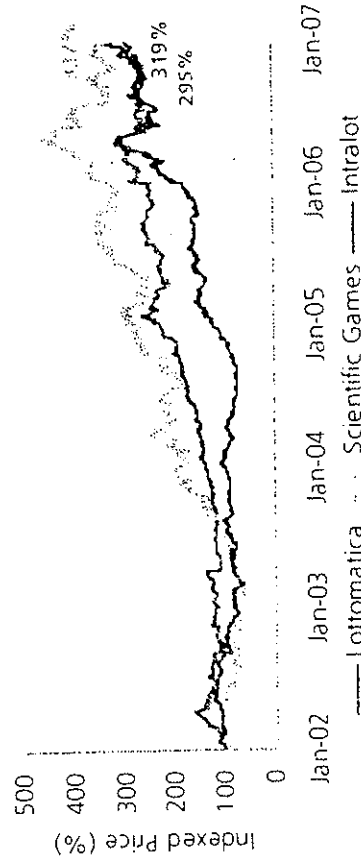
Note: Market estimates as of January 8, 2007 (multiples calendarized to December year-end)

Relative Share Price Performances of Lottery Companies

Listed Single Jurisdiction Lotteries



International Lottery Operators



Source: Datastream (rebased to 100)

Precedent Gaming Transactions

There are a limited number of precedent M&A transactions in the lottery sector worldwide

- The only single jurisdiction lottery transaction of size is the De Agostini acquisition of a 59% stake in Lottomatica in 2001

Global Gaming M&A Transactions Over \$1 Billion in the Last 5 Years¹

Announced Date	Target Name	Target Country	Acquirer Name	Acquirer Country	EV (\$mm)	EV/EBITDA (x)
Oct-06	Harrah's Entertainment	US	Apollo/TPG	US	27,821	10.2
May-06	Azlar Corp	US	Columbia Sussex	US	2,669	11.4 ²
Mar-06	Codere SA (42.0%)	Spain	Masampe Holding BV	Spain	1,454	11.1
Mar-06	Kerzner International	US	Investor Group	Several	3,600	17.0
Jan-06	Hyatt Regency (51.6% stake)	Greece	BC Partners	UK	1,181	9.4
Jan-06	GTech ³	US	Lottomatica	Italy	4,784	9.6
Oct-05	Coral Eurobet	UK	Gala Group	UK	3,837	11.1
Aug-05	Gala Group (30% stake)	UK	Permira	UK	3,387	12.2
May-05	Stanley Racing	UK	William Hill	UK	935	13.5
Feb-05	Sisal	Italy	Clessidra	Italy	549	7.0
Nov-04	Argosy Gaming	US	Penn National Gaming	US	2,210	8.2
Sep-04	Harrah's/Caesars' Assets	US	Colony Capital	US	1,240	8.5
Aug-04	Trump Hotels & Casino Resorts, Inc.	US	DLJ Merchant Banking	US	1,936	8.1
Jul-04	Caesars Entertainment	US	Harrah's Entertainment	US	9,440	8.0
Jun-04	Mandalay Resort	US	MGM MIRAGE	US	7,756	10.0
Feb-04	Tab Ltd	Australia	Tabcorp Holdings Ltd	Australia	1,574	11.5
Feb-04	Coast Casinos Inc.	US	Boyd Gaming	US	1,296	7.5
Sep-03	Horseshoe Gaming Holding Corp.	US	Harrah's Entertainment	US	1,450	7.3
Jun-03	Jupiters	Australia	Tabcorp Holdings Ltd	Australia	1,101	9.3
Feb-03	Gala Group	UK	Candover/Cinven	UK	1,949	10.9
Aug-02	Coral Eurobet	UK	Charterhouse	UK	1,350	c 10
Nov-01	Lottomatica	Italy	De Agostini	Italy	909	5.8
Average						9.9

Notes

- Includes selected lottery transactions below \$1 billion
- Based on Morgan Stanley 2006E EBITDA estimate
- Last 12 months EBITDA
- Blue bars represent transactions in which UBS was involved

Valuation Assumptions

Key Variables

- ◆ Length of Concession: 30 – 50 years
- ◆ Growth Rate: 2.5% - 4.5%
- ◆ Tax Rate: 0% - 35%
- ◆ Discount Rate: 5.5% - 7.5%
- ◆ Margins: Improvements to national average of 31.0% from 2009 to 2011

General Assumptions

- ◆ Operating projections through 2009 as provided
- ◆ Growth thereafter for ranges of key variables
 - margins held constant in a steady state
- ◆ Capital expenditures assumed to be approximately \$5 million per year to be conservative, well above historical amounts
- ◆ No new games assumed
- ◆ Depreciation assumes to equal capex
- ◆ No working capital changes

First Ten Years Projections (Base Case)

	2005A	2006B	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Revenue	\$3,663	\$3,801	\$3,821	\$3,821	\$3,821	\$3,955	\$4,093	\$4,236	\$4,384	\$4,538	\$4,697	\$4,861
% Growth		3.8%	0.5%	0.0%	0.0%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
EBITDA	1,069	1,081	1,102	1,121	1,122	1,161	1,201	1,243	1,287	1,332	1,379	1,427
% Margin	29.2%	28.4%	28.8%	29.3%	29.4%	29.4%	29.4%	29.4%	29.4%	29.4%	29.4%	29.4%
% Growth		1.1%	1.9%	1.7%	0.1%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Capital Expenditures	0.2	0.2	5	5	5	5	5	5	5	5	5	5
% of Revenue	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%

Note

1 Revenue and EBITDA based on guidance from State of Texas through 2009 and UBS estimates thereafter. Capex estimate per UBS estimates under private ownership scenario

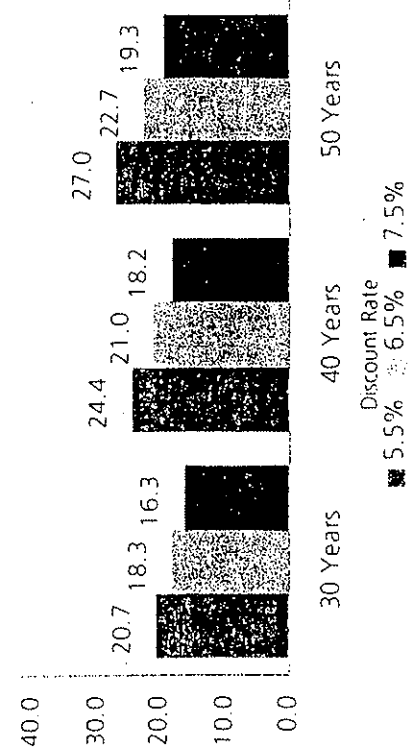
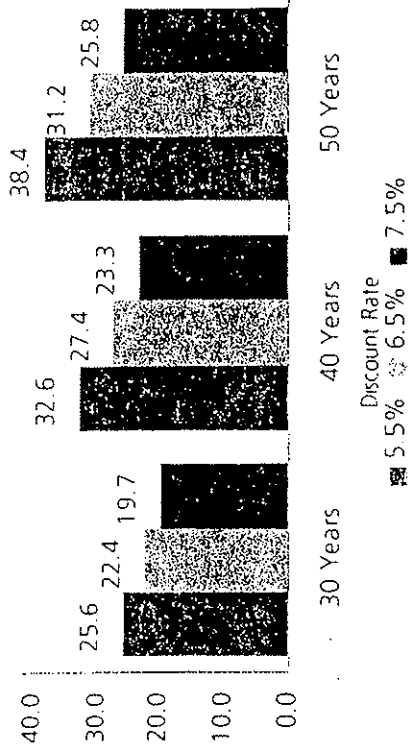
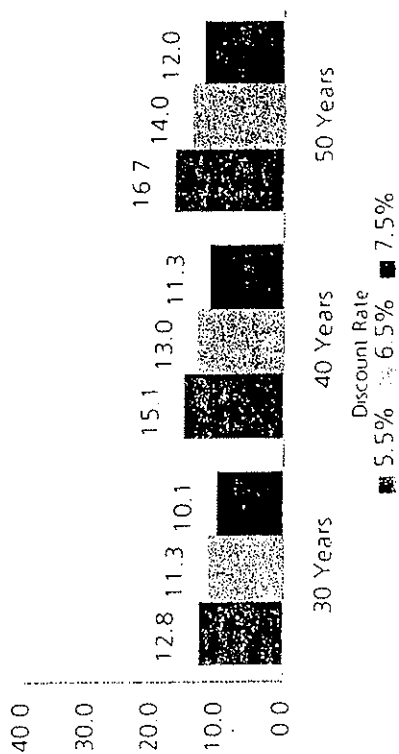
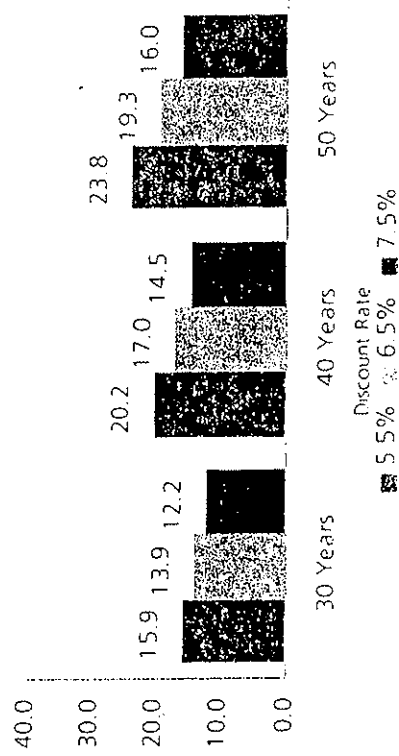
Discounted Cash Flow Valuation

The charts below illustrate the DCF value under different growth, tax, concession length and discount scenarios with operating margins held constant

Accelerated (4.5%)

Inflationary (2.5%)

(\$ billions)



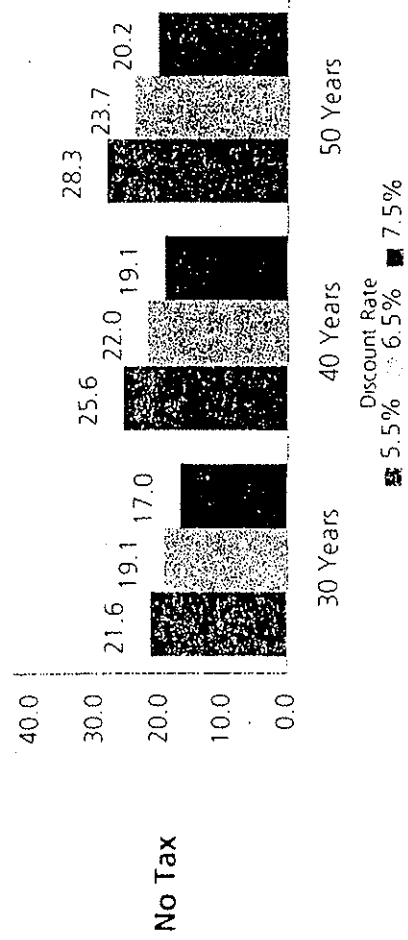
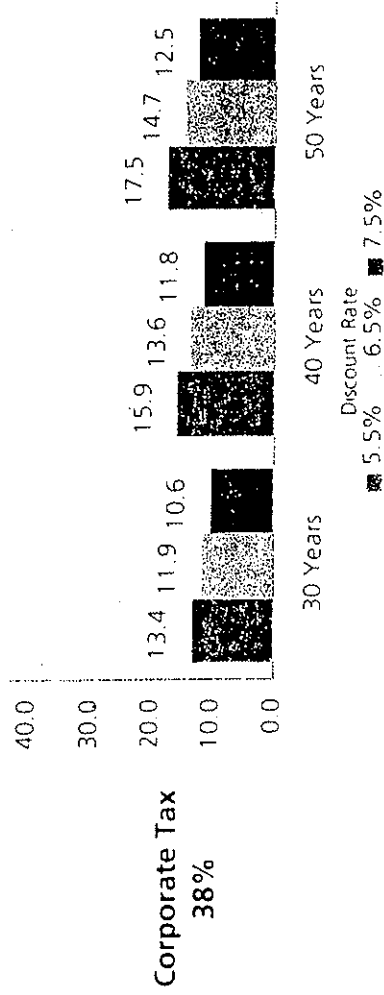
Discounted Cash Flow Valuation

The charts below illustrate the DCF value under different growth, tax, concession length and discount scenarios with margin improvement to the national average by 2011, valuations are incrementally higher

(\$ billions)

Inflationary (2.5%)

Accelerated (4.5%)



Returns Based Valuation

The following analysis illustrates possible upfront payments from buyers with varying return hurdles and exit multiple assumptions

- ◆ Leveraged buyout assumptions:
 - using base case assumptions per page 9, no upside growth or margins
 - average debt raised at 8.0%
 - total debt of approximately 10x 2006 EBITDA
 - 5 year exit, assuming a long dated concession

	Upfront Payment (\$bn)				
	Required Return				
Exit Multiple	10.0%	12.5%	15.0%	17.5%	20.0%
12.0x	\$13.9	\$13.6	\$13.3	\$13.0	\$12.8
12.5x	14.3	13.9	13.6	13.3	13.0
13.0x	14.7	14.2	13.9	13.6	13.3
13.5x	15.0	14.6	14.2	13.9	13.5
14.0x	15.4	14.9	14.5	14.1	13.8

Tax¹

	Upfront Payment (\$bn)				
	Required Return				
Exit Multiple	10.0%	12.5%	15.0%	17.5%	20.0%
12.0x	\$14.3	\$13.9	\$13.6	\$13.3	\$13.1
12.5x	14.7	14.3	13.9	13.6	13.3
13.0x	15.1	14.6	14.2	13.9	13.6
13.5x	15.4	15.0	14.5	14.1	13.8
14.0x	15.8	15.3	14.8	14.4	14.1

No Tax

	Upfront Payment (Multiple of 2007E EBITDA)				
	Required Return				
Exit Multiple	10.0%	12.5%	15.0%	17.5%	20.0%
12.0x	12.6x	12.3x	12.0x	11.8x	11.6x
12.5x	12.9x	12.6x	12.3x	12.1x	11.8x
13.0x	13.3x	12.9x	12.6x	12.3x	12.1x
13.5x	13.6x	13.2x	12.9x	12.6x	12.3x
14.0x	14.0x	13.6x	13.2x	12.8x	12.5x

	Upfront Payment (Multiple of 2007E EBITDA)				
	Required Return				
Exit Multiple	10.0%	12.5%	15.0%	17.5%	20.0%
12.0x	13.0x	12.6x	12.3x	12.1x	11.9x
12.5x	13.3x	12.9x	12.6x	12.3x	12.1x
13.0x	13.7x	13.3x	12.9x	12.6x	12.3x
13.5x	14.0x	13.6x	13.2x	12.8x	12.5x
14.0x	14.4x	13.9x	13.5x	13.1x	12.8x

Note:

¹ Assumes 38% corporate tax

Legislation and Regulation

Issues to Consider for Optimizing the Value of the Texas Lottery

- ◆ Straightforward and transparent regulatory / monitoring regime
- ◆ Need for upfront payment proceeds vs. ongoing participation
- ◆ Significant freedom for operator to manage lottery business, including:
 - ability to introduce new games
 - advertising
 - prize payout levels
 - interaction with existing vendors
 - ability to increase penetration of points of sales
 - price setting
- ◆ Reasonable profit sharing and risk allocation provisions
- ◆ Long-term business opportunity (30+ years)
- ◆ Limited gaming competition and substantial barriers to entry
- ◆ Reasonable lease termination provisions that do not hamper financing or operations
- ◆ Limited requirements for capital expenditures or other investment
- ◆ Potential impact of Franchise (Margin) Tax on cash flow
- ◆ Transition plan to facilitate successful conversion of lottery to new management
- ◆ Minimal restrictions on future transfer of ownership

SECTION 3

Use of Proceeds

State of Indiana

Proposed Use of Proceeds from Lease of Hoosier Lottery

- ◆ Indiana Governor Mitch Daniels has proposed using the proceeds from the lease of the Hoosier Lottery to fund a proposed higher education program, introduced in December, 2006
- ◆ From the lease of the Hoosier Lottery, Governor Daniels expects:
 - up-front payment of at least \$1 billion (assuming a 30-year lease)
 - \$200 million fixed annual payment (average of the last four years of Hoosier Lottery profits)
 - ongoing percentage of the operator's revenue (5% of revenues above \$700 million has been suggested)
- ◆ Hoosier Lottery generated revenues of \$734.8 million and EBITDA of \$219.6 million in 2006
- ◆ Under Governor Daniels' plan, proceeds from the lease of the Hoosier Lottery would be used as follows:
 - **\$6 billion, or 60% of the up-front proceeds, would be placed in a permanent endowment to create a new Hoosier Hope Scholarships program** for top Indiana students who remain in-State after graduation. Interest would be used for scholarships for outstanding high school graduates who enroll in a full-time degree program at any private or public institution in Indiana. Students attending four-year institutions could receive a total of \$20,000 for tuition, fees, books, and other expenses; those attending two-year institutions could receive a total of \$5,000, with the opportunity to automatically be eligible for two additional years of funding at a four-year institution. The awards would take the form of forgivable loans that would not have to be repaid if the student stays in Indiana to work for three years after completing studies. Scholarships would be based on merit and the number of scholarships awarded each year would be based on the endowment's annual earnings
 - **\$4 billion, or 40% of the up-front proceeds, would be used to create the World Class Scholars Fund** to attract outstanding faculty to public colleges and universities in Indiana from outside the state. Though the faculty grants could be accessed only by public colleges and universities, Indiana's private colleges could participate through collaborative proposals. The World Class Scholarship Fund would be amortized over 10 years, and all grants would require matching contributions from the institutions that receive them. All grants would require matching contributions from the universities, and it is expected that most would be matched on well over a dollar-for-dollar basis
 - **The \$200 million annual payment, plus the State's share of any surplus revenues, would be used to meet costs currently being paid by the Hoosier Lottery's annual profit.** Currently, approximately \$30 million per year is used for teacher pensions, \$30 million is used for police and firefighter pensions, and \$140 million is used for auto excise tax relief



State of Illinois

Proposed Use of Proceeds from Lease or IPO of Illinois Lottery

- ◆ Illinois Governor Rod Blagojevich has proposed using the proceeds from the lease or IPO of the Illinois Lottery to fund a proposed \$10 billion education package¹, introduced in May, 2006
- ◆ From the lease or IPO of the Illinois Lottery, Governor Blagojevich expects an up-front payment of approximately \$10 billion
- ◆ Illinois Lottery generated revenues of \$1.814 billion and net income of \$671.6 million in 2005
- ◆ Under Governor Blagojevich's plan, proceeds from the lease or IPO of the Illinois Lottery would be used as follows:
 - \$4 billion, or 40% of the up-front proceeds, would be used to help fund a \$6 billion spending program for education over the next four years for classroom programs, school construction, expanded preschool and full-day kindergarten, merit pay for teachers, and new textbooks. This money would also be used to help fund failing students and schools. The remaining \$2 billion would be generated by the following: approximately \$500 million would be generated through investment proceeds from the \$4 billion (as it sits in an interest bearing account) and from income tax paid by the new operator of the lottery; and \$1.5 billion from a mix of revenue growth and special fund transfers (mirroring the \$400 million annual increases seen over the last four budgets).
 - \$6 billion, or 60% of the up-front proceeds, would be invested in a 25-year annuity to the Common School Fund that would generate an estimated \$650 million annually for education funding until Fiscal Year 2025. The \$650 million annual amount is expected to replace the annual revenues the State currently receives from operation of the Illinois Lottery
- ◆ The Illinois Lottery would be regulated by a new, independent, bipartisan board, consisting of seven members appointed by the General Assembly (four appointees, one from each caucus), the Governor (one), the State Comptroller (one), and the State Treasurer (one).

Note

- 1 According to a press release dated 05/23/06 from the Office of the Governor



SECTION 4

Next Steps

Next Steps

The following items should comprise the next steps towards the private financing:

STEP 1

- ◆ Preliminary decision on whether to pursue this opportunity
- ◆ Develop understanding of legislative requirements and strategy

STEP 2

- ◆ Engage UBS to assist State in evaluation of alternatives, development of required legislation, and implementation of preferred alternative

STEP 3

- ◆ Hire Big Four Accounting Firm
- ◆ Hire State Counsel
- ◆ Modeling Discussion
 - financial Projections
- ◆ GAAP Audit of Financial Statements
- ◆ Form C-corp
- ◆ Form Management Team

Tasks and Responsibilities

UBS will assist the State of Texas in the Sale/IPO process in the following ways:

- ◆ Advisory in relation to legislative and regulatory development process
- ◆ Project management
- ◆ Business plan and investor receptivity assessment
- ◆ Valuation analysis
- ◆ Transaction structure
- ◆ Coordination of due diligence
- ◆ Coordination of Information Memorandum (IM) or, for IPO, prospectus (industry overview, business and strategy sections)
- ◆ Coordination/preparation of roadshow/marketing/PR
- ◆ For IPO, syndicate management
- ◆ For IPO, pricing/trading/settlement/stabilization
- ◆ For IPO, underwriting and other relevant legal agreements

Tasks and responsibilities of the other parties:

State of Texas	State's Counsel	Underwriters' Counsel (for IPO)
<ul style="list-style-type: none"> ◆ Due diligence ◆ Support in preparation of IM or prospectus ◆ Capital structure ◆ Corporate actions (e.g. stock split, share capital increases, etc.) ◆ Management meetings or roadshow presentation ◆ Communication strategy 	<ul style="list-style-type: none"> ◆ Corporate and regulatory actions ◆ Drafting of IM / prospectus ◆ Due diligence ◆ Publicity guidelines ◆ Review concession agreement and, for IPO, underwriting and other relevant legal agreements ◆ For IPO, legal opinion 10b(5) 	<ul style="list-style-type: none"> ◆ Review and contribution to prospectus ◆ Due diligence ◆ Review and input into publicity guidelines ◆ Research guidelines ◆ Underwriting agreements and other relevant legal agreements ◆ Legal opinion 10b(5)
Auditor(s) <ul style="list-style-type: none"> ◆ Audit financials ◆ Financial due diligence ◆ For IPO, review financial disclosure ◆ General advisory to parties on accounting and disclosure issues ◆ For IPO, comfort letters 	Public Relations Firm <ul style="list-style-type: none"> ◆ Manage the public relations and media in connection with the sale or IPO 	Printers (for IPO) <ul style="list-style-type: none"> ◆ Process editing changes in subsequent versions of prospectus and distribute new drafts ◆ Print prospectus

APPENDIX A

Supplemental Information

Asset Class: Lottery

	Trade Sale/Concession	IPO	Licensing
Illustrative Enterprise Value (\$)	\$10 bn	\$10 bn	\$10 bn
Debt to Equity %	80/20 -- 60/40	60/40 -- 50/50	N/A
Equity Value	\$2-4 bn	\$4-5 bn	N/A
Initial Equity Market Transaction Limit	100%	30-49%	N/A
Equity Proceeds	\$2-4 bn	\$1-3 bn	N/A
Debt Proceeds	\$8-6 bn	\$6-5 bn	N/A
Total Gross Proceeds	\$10 bn	\$7-8 bn	\$5 bn
Structure Comment			
■ Type	Fixed Rate, Floating & Zero ¹	Fixed Rate, Floating & Zero ¹	Fixed Rate, Floating & Zero ¹
■ Maturity	5-20+ years	5-20+ years	5-20+ years
■ Tranching	Yes	Yes	Yes
Investment Grade Rating	Possible	Possible	Possible
Amount of Insurance Available	\$2-5 bn	\$2-5 bn	\$2-5 bn
Bank Capacity	Adequate (Bridge)	Adequate (Bridge)	Adequate (Bridge)

Note
 1 Zero coupon could be natural or synthetic