Definition of Ratings:

Buy: at least 20% undervalued
Hold: appropriately valued
Sell: at least 20% overvalued

Industry:

Services-Gambling

Fundamentals:

Market Cap: **$1.07B**

Close 4/27/2002: **$18.60**

52-Week High: **$19.00**

52-Week Low: **$7.50**

Price/Sales: **1.33**

Price/Book*: **4.26**

Debt/Equity*: **4.97**

Net institutional ownership: **74%**

Company Summary:
Station Casinos, Inc. is a gaming company that owns and operates seven distinctly themed hotel/casino properties and two smaller casino properties in the Las Vegas metropolitan area. The Company also owns and provides slot route management services in southern Nevada.

*As of 4/27/02

(NASDAQ: STN)

Recommendation: **SELL**
Bet on the horses before betting on Station.

May 23, 2002

Davin Bernstein &
Christopher Kirkman
Portfolio Manager: Javier Fernandez

Investment Rating: Without any distinctive sustainable competitive advantage and estimated fundamental value far below current market value, we expect a significant depreciation in the value of this company as the market's elevated expectations of future performance become unrealized.

Yale School of Management
135 Prospect Street
New Haven CT, 06511

Disclaimer: Please see the disclaimer at the back of this report for important information

Investment Rating

We are initiating coverage of Station Casinos with a SELL rating. The stock has appreciated recently due to above expected earnings in the first quarter of 2002 Q1. Our fundamental valuation of this stock is below its current market price, driven by our belief that Station does not have any sustainable competitive advantage in its marketplace. In addition, we believe that the un-diversified nature of this stock leaves the investor with a significant degree of exposure to certain factors, which are underestimated in the stock's current market capitalization. We feel that the market's valuation will gradually come in line with our expectations for the company's outlook and drive the stock down to a more reasonable value.

Key Criteria for Recommendation:

- No basis for expected revenue growth greater than the overall regional population growth, which is high, but below the market's expectation of company performance.

- Recent EBITDA margin increases, while favorable, cannot improve to a greater amount due to factors such as higher energy and labor costs and inherent structural limitation in the industry.

- Stock is trading at a premium EV/EBITDA (9.1X) to the sector average, which is trading at a premium to the market. We believe that because of Station's high exposure to the food and beverage market in Las Vegas, this comparable should reflect this exposure, which it does not. If it did, the company would appear significantly overvalued.

- No significant barriers to entry or fundamental sustainable competitive advantage. In both the casino and food and beverage market, the key mantra is "location, location, location." While company's management touts their advantage by NOT being on the strip, which has some validity in reference to their customer base, this does not create any barriers to entry which would support a favorable long-term outlook.

- Heavy debt load and significant interest expense. Standard & Poor's rates corporate bonds as a BB. However, the company's bond issues are trading at premium to the market. While we believe the company is capable of meeting its debt-obligations, we do not believe that tight operational efficiencies necessary in a company with such a high degree of current and targeted leverage allow for better than average EBITDA margins.

- Lack of diversification is compounded by management-targeted consolidation in the slowest growing region in the industry, Las Vegas. In 2000, Station divested their operations in Missouri, one of the fastest growing markets in the industry in favor of acquiring two new properties in their primary market of Las Vegas. We believe that Station's focus on a single demographic in a single market gives the company significant non-diversification risk, which is not incorporated in the market's current valuation. Without a portfolio of properties across the country to diversify the company, it will always be susceptible to changes in Las Vegas local population demographic trends. In addition, management does not view this as a concern, and consequently we do not expect action to address this issue.

Who is Station?

In the company's own words:

"We are a gaming company that owns and operates eight distinctly themed hotel/casino properties and two smaller casino properties throughout the Las Vegas metropolitan area. Our growth strategy includes the master-planned expansion of our existing gaming facilities in Nevada, as well as the evaluation and pursuit of additional acquisition or development opportunities in Nevada and other gaming markets. Each of our casinos caters primarily to local Las Vegas area residents, offering convenience and choice with our strategically located properties."[1]

What is their Value Proposition?

While management cites many aspects of their value proposition, we believe the two factors below distinguish this organization from others in the sector and are key to proper valuation:

- Targeted Customer Base: *"Unlike many of the more high-profile companies with a presence in Las Vegas, who achieve a significant portion of their revenues from tourists, Station is focused specifically on the local market."* Station's management cites this as a reason why none of their properties are located on the main strip *"Our patrons view our hotel and casino product as a preferable alternative to attractions located on the Las Vegas Strip and downtown Las Vegas."* Station differs from most of the companies in this industry in that it caters to the local population, who has a different set of preferences than the tourist.

- Provision of a High-Value Experience: While all casinos strive to provide a 'high value experience', Station distinguishes itself in two ways 1) *"we believe the value offered by restaurants at each of our casino properties is a major factor in attracting local gaming customers, as dining is a primary motivation for casino visits by many locals."* 2) *"In addition, our operating strategy focuses on slot and video poker machine play. Our target market consists of frequent gaming patrons who seek not only a friendly atmosphere and convenience, but also higher than average payout rates."*.

[1] From 10-K. Bolded comments are not original.

Competitive Advantages & Strategic Analysis:

A Retail Food & Beverage Company with Casino Revenues:

Station's focus on the local Las-Vegas market puts it in a different category than its peers. While its revenues are still largely casino-based, this percentage is declining in favor of food and beverage and hotel revenues. The cyclicality and fickleness of restaurant concepts (and their lower average PE) means that Station might be better to stay a gaming stock in the long run.

	2001	% total	% change	2000	% total	% change	1999
Casino revenues	659,276	72%	-18.4	807,880	76%	5.7	764,089
Casino expenses	287,637	32%	-22.8	372,826		4.6	356,365
Margin	*56.4*			*53.9*			*53.4*
Food and beverage revenues	139,983	15%	2	137,198	13%	(2.8	141,116
Food and beverage expenses	85,719	9%	2.2	83,879	8%	(5.6	88,898
Margin	*38.8*	0%		*38.9*			*37*
Room revenues	47,558	5%	2.8	46,260	4%	7.9	42,870
Room expenses	19,289	2%	17.5	16,416	2%	3.5	15,860
Margin	*59.4*			*64.5*			*63*
Other revenues	63,980	7%	-5.9	67,999	6%	9.2	62,286
Total Revenues	910,797	100%		1,059,337	100%		1,010,361
Selling, general and administrative expenses	165,977	18%	-8.1	180,659	17%	(5.3	190,753
Corporate expenses	25,952		-3.8	26,974		17.2	23,007

Source: Company Financials

Furthermore, the casino revenues are in a large part driven by food and beverage revenues, as local consumers will tend to gamble at locations they choose based upon their food & beverage, not gaming, preferences. Consequently, Station gives itself significant exposure to the highly competitive retail food and beverage (F&B) industry. While Station's casino expertise could give it an advantage over national, other food and beverage retailers with less casino/F&B expertise, we do not view this as enough of a sustainable advantage to warrant its current high valuation.

Better Odds:

We do not believe that provision of higher than average payout rates is a sustainable competitive advantage. All of Station's competitors have as much of an ability to decrease their winnings (and increase their customer's winnings) as Station does. Increased competition on this front will only serve to decrease margins.

Strategically Undesirable Location:

Station strategically locates its properties at sub-premium locales. Clearly this does not create a barrier to entry. While it could possibly decrease acquisition expenditures, it would also tend to decrease the liquidity value of Stations properties relative to other casinos and the market value of its assets.

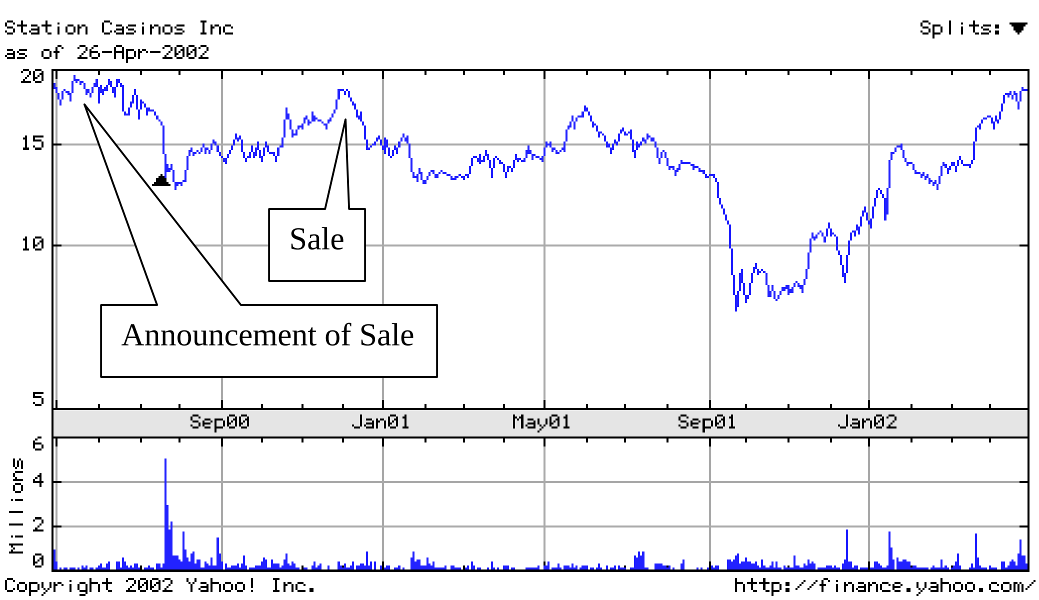
Consolidation Instead of Diversification:

As discussed in our industry analysis, we feel that diversification is a highly positive valuation factor for companies in this industry (see Gaming Industry: Small and Mid Cap Casino Stocks, April 8, 2002). In 2000, Station's management sold their Missouri properties (refer to our earlier report "Heartland Gambling Comes of Age", on the acquirer, Ameristar, NASDAQ: ASCA), the only non-Las Vegas market in which they had any presence, and purchased two properties in their home market, costing a similar amount yet generating less revenues than the Missouri properties. Missouri is currently the fastest growing gaming market in the United States, and caters to a large degree to the local population, which Management describes as a competitive advantage of Station Casinos. This might have been done because the expansion plans of the Missouri property required cash to complete ($170 million by Ameristar) which Station does not appear to have. By trading down to the two finished casinos in Las Vegas, they are able to maintain cash reserves.

Year-Over-Year % Change Gaming Revenue in the U.S., 1995-2002E					
	1998	1999	2000	2001	2002E
Las Vegas	0%	18%	7%	-2%	1%
Atlantic City	3%	3%	3%	0%	3%
Mississippi	10%	15%	5%	2%	3%
Missouri	14%	10%	6%	15%	11%
Iowa	12%	7%	13%	3%	4%
Nevada (all)	3%	12%	6%	-1%	1%

Source: Merrill Lynch Estimates

Station may have had a competitive advantage in the Missouri market, as other casinos would tend to be focused on gaming, and food and beverage competitors would not have the capability of adding gaming to their offerings, creating a barrier-to-entry for Station. We believe that while the market indicated its disapproval of this sale, the stock price has risen to its pre-sale announcement levels. The market seem to ignore both the diversification concerns and the decline in revenue concerns we now see in this stock.



		2001	% change	2000	% change	1999
Net revenues—total		**839,361**	**-15.4**	**991,678**	**5.2**	**942,469**
	Major Las Vegas Operations (a)	797,213	27	627,968	7.4	584,852
	Missouri Operations (a)	—	-100	315,422	0.6	313,439
	Other Operations and Corporate (a)	42,148	-12.7	48,288	9.3	44,178
Operating income (loss)—total		**140,839**	**-42**	**242,812**	**741**	**28,871**
	Major Las Vegas Operations (a)	172,539	4.5	165,138	12.2	147,217
	Missouri Operations (a)	—	-100	102,882	220.7	(85,269
	Other Operations and Corporate (a)	(31,700	-25.8	(25,208	23.8	(33,077
Cash flows from:						
	Operating activities	115,145	-29.7	163,696	(5.4	173,058
EBITDA, As Adjusted (b)—total		**219,167**	**-20**	**273,847**	**15.6**	**236,970**
	Major Las Vegas Operations (a)	240,003	13.6	211,252	13.2	186,677
	Missouri Operations (a)	—	-100	82,636	19.4	69,223
	Other Operations and Corporate (a)	(20,836	-4	(20,041	(5.9	(18,930
EBITDA, As Adjusted (b), Adjusted for the Sunset		**219,167**	**-20**	**273,847**	**12.7**	**242,890**
	Major Las Vegas Operations (a)	240,003	13.6	211,252	9.7	192,597

Source: Company Financials

High Value Experience:

Station offers that part of their value proposition is delivering a "high value experience." Recently, the stock price has responded to improving EBITDA margins that drove increases in Net Income. A "high value experience", not to mention improved payoff ratios, are not consistent with maintaining above industry average operating margins. We expect either a degradation in quality and consequent decline in market share, leading to decreased revenues or worsening margins due to need to maintain comparative quality leading to increased revenues (larger market share) but decreased net income.

A Note about Disclosure Practices:

Management has recently stopped reporting results from individual properties. Rather it has chosen to lump them together into a single category. This decreases transparency of results and lends question as to performance consistency across properties. We believe that this lack of transparency might indicate an operational concern at one or more of Station's properties that is not currently implicit in the market's valuation.

Valuation

We attempted three methods to determine the value of Station, two rudimentary and one detailed analysis of future cash flows. In each case we found the valuation to be below existing share prices, supporting our recommendation that the stock price is currently overvalued.

Key Comparable Measures

Investments in Las Vegas gaming do not produce better than peer results, and this will increasingly be reflected in multiples paid for properties. Currently, Las Vegas properties trade for a premium to other casino properties, and this bias appears unjustified in light of growth opportunities in the various gambling markets nationwide.

The result is that we believe that Station is overpriced, and investors may want to wait for a depreciation of the stock before buying into it.

: Estimated Size of the U.S. Gaming Market

	1995	1998	2001	6-YR CAGR
Total Nevada	$7,366.4	$8,064.1	$9,468.4	4.3%
Las Vegas Strip	$3,607.4	$3,812.4	$4,703.2	4.5%
Atlantic City	$3,747.6	$4,032.2	$4,317.8	2.4%
Riverboats	$4,732.0	$7,299.6	$9,963.5	13.2%
Native American	$4,175.9	$7,890.9	$11,965.7	19.2%
Other	$457.5	$1,256.0	$2,980.1	36.7%
Total	**$20,479.3**	**$28,542.8**	**$38,695.5**	**11.2%**

Source: Merrill Lynch and State Gaming Commissions.

Ratio Analysis

Station's high P/E Ratio indicates a company that is overvalued relative to the earnings potential of itself, but also of other firms in the industry and sector.

STA, on a Price/Sales basis, trades at a slight premium to its peers and the market. The Price/Sales trend demonstrates that the market initially has showed some skepticism regarding the industry's growth strategy.

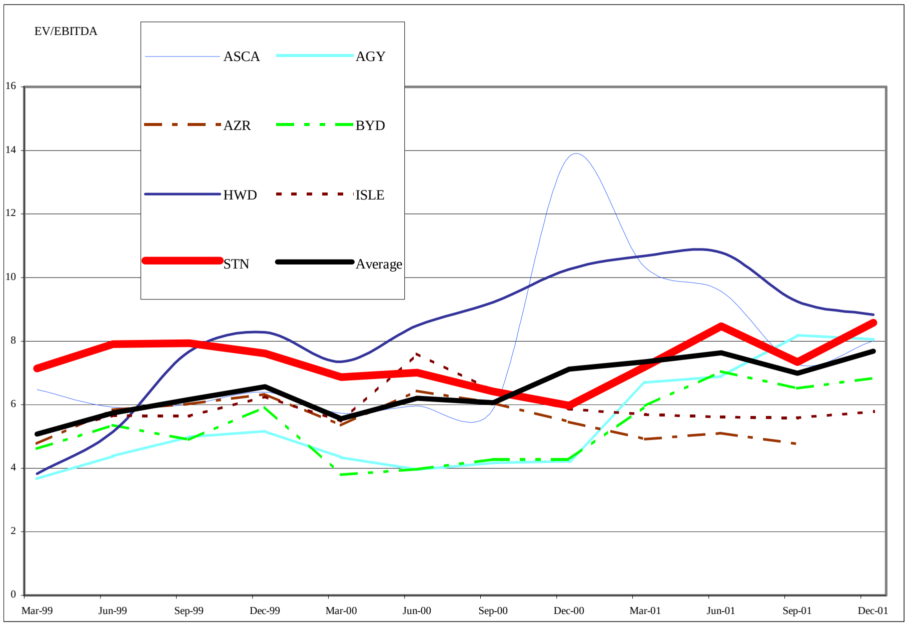
STA trades on a premium Price/Book ratio to the market, but not its peers. We believe that STA's book value comes from recent debt agreements and that debt dominates this firm far more than the typical one to two thirds leverage one would see in the market as a whole.

Ratios	12/31/00	12/31/01
Income Statement		
Operating Margin	0.24	0.15
Pre-Tax Margin	0.15	0.05
Net Margin	0.09	0.03
Fixed Charge Coverage	2.57	1.36
Current Ratio	2.51	1.04
Quick Ratio	2.48	1.00
Working Capital	188,292,000	4,227,000
Balance Sheet		
Total Assets/Total Liabilities	1.25	1.18
D/E	3.43	4.97
Statement of Cash Flows		
Cash Flow from Ops/CapEx	N/A	N/A
Depreciation/Cash flow from Ops	0.41	0.66
CapEx/Depreciation	-	-
Combination		
Return on Equity	0.32	0.08
Return on Average Equity	0.37	0.07
Return on Total Capital	0.19	0.09
Average Days Receivable	10.97	11.77
Receivables Turnover	33.28	31.00
Inventory Turnover	198.57	216.44
Debt to Cash Flow	6.05	10.74

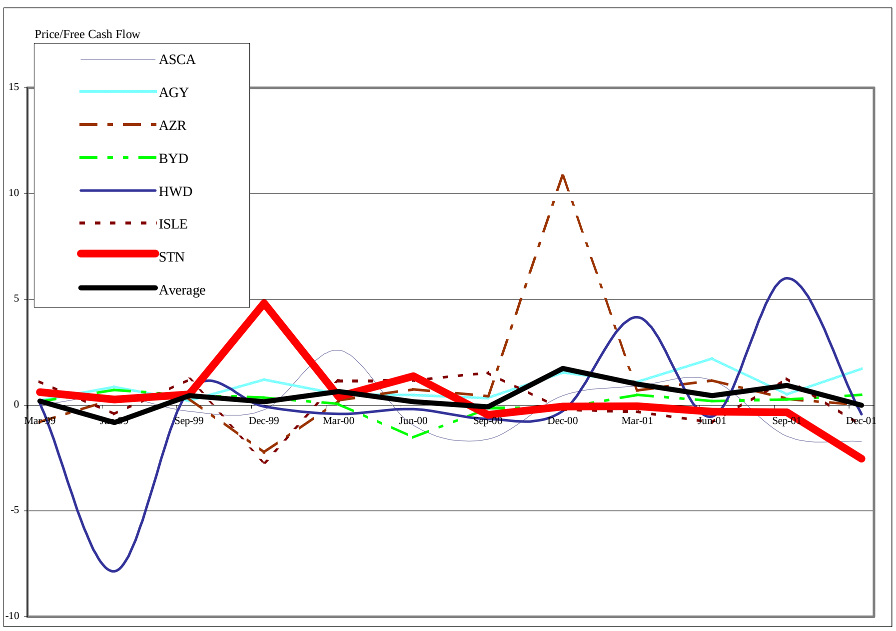
Many ratios and margins are falling, making us wonder why the market believes they will achieve even a minimal level of earnings and profitability growth. We find the argument by some analysts that Station's land assets contribute to a higher valuation to be unconvincing. Our own assumptions actually assume a higher EBITDA than others, but the results still don't warrant a valuation like we see in the market right now.

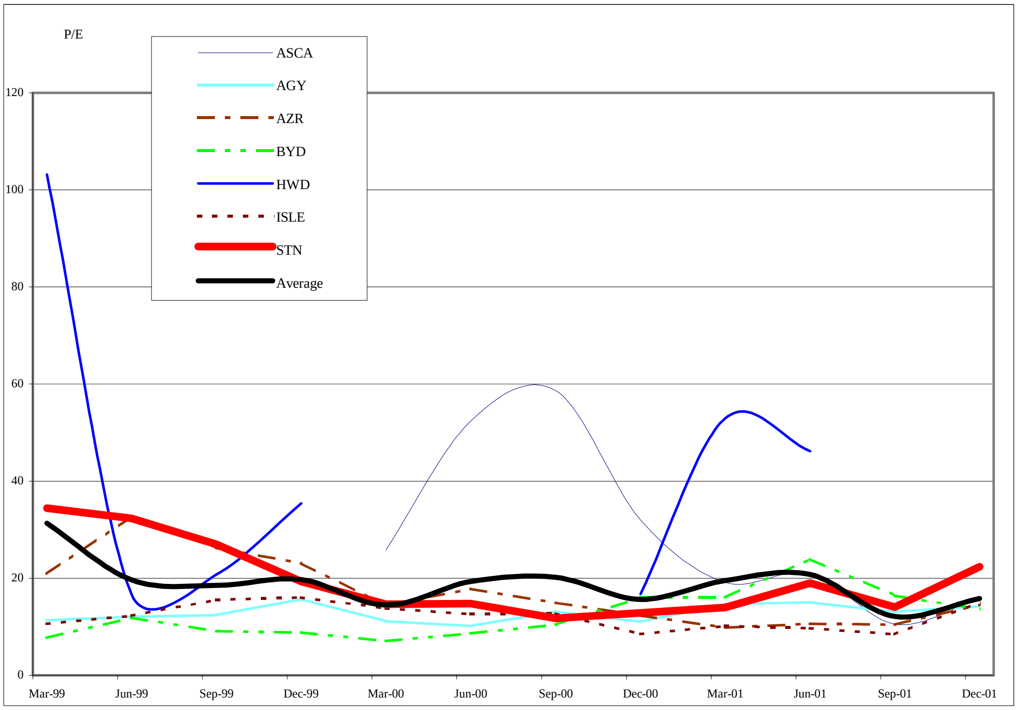
Comparative Analysis

Station has traded above the industry average for nearly a year…

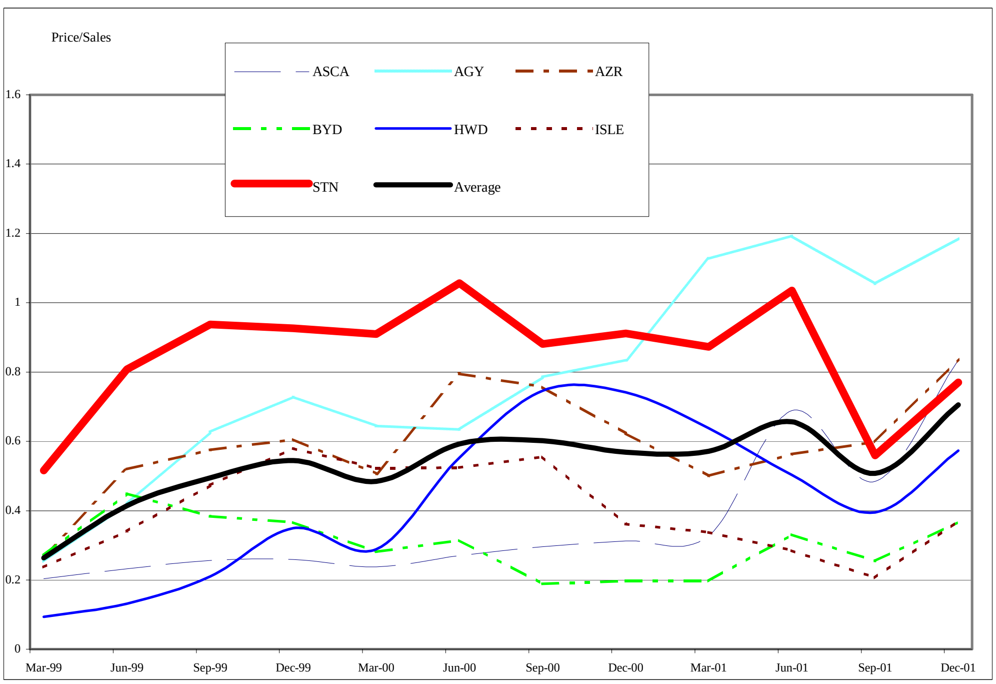


Yet performs worse than its peers on a price to cash-flow basis, as well as on a P/E basis:

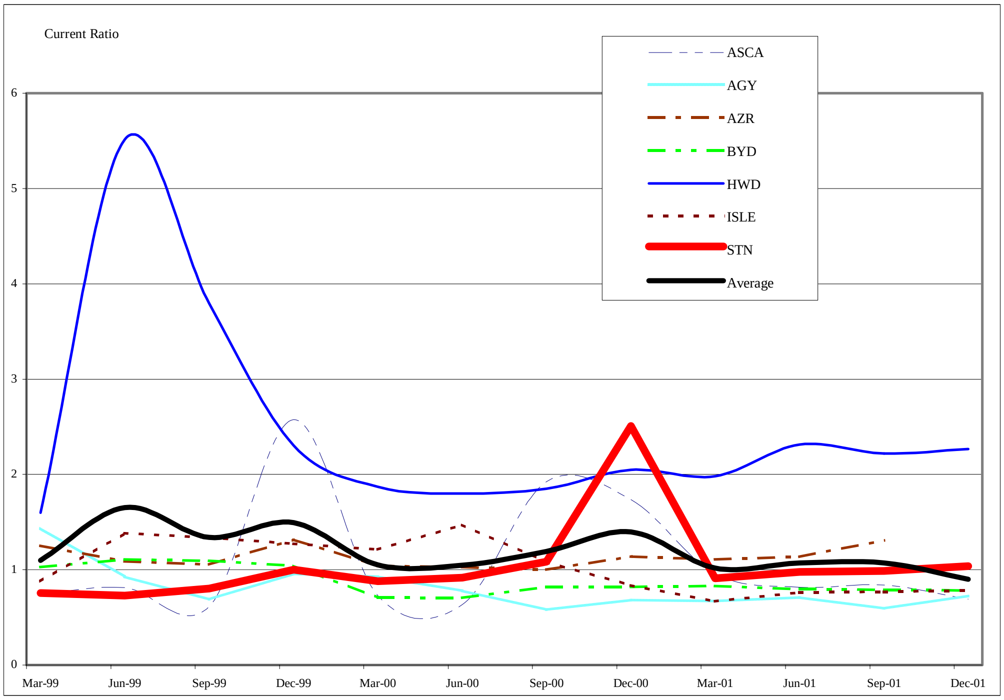




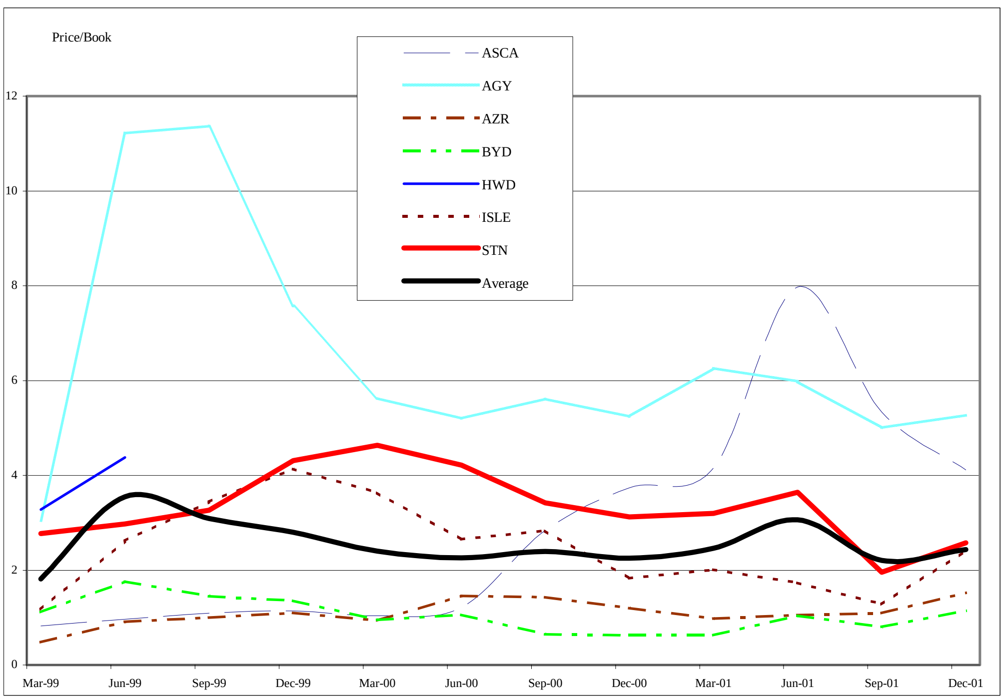
Station's price to sales ratio is also higher than its peers.



Station continues to have success keeping its current ratio at the industry level (except when it was trading casinos).



But its book value is increasing relative to its price:



Source: Bloomberg

STA is trading at almost twice the levels suggested by any of our evaluation methods. A price in the $10-13 range seems more reasonable given the opportunities available to this company in its single market. The company traded in this range late last year, but we note with some concern current efforts by the company to "manage" earnings. While this certainly occurs with many companies, their attempt to lower expectations sharply in the 4th quarter conference call, only to pre-announce exceeded expectations for 1st quarter 2002, seems a thinly disguised attempt to make the stock appear stronger than it really is.[2]

This is not to say that we expect earnings to fall off. The company does have improving margins in key areas and should be able to provide consistently improving earnings growth moving ahead, barring any economic turndown in the Las Vegas market.

The company is highly levered and its debt coverage, sufficient in good times, may drop precipitously if an external shock or sustained downmarket occurred. This is not fiscal responsibility, and Station Casinos could easily default on its debt given an unforeseen circumstance at even one of its properties. Its interest coverage of 1.5 suggests that they are bumping against standard creditor limits and do not have room to recover if earnings takes a hit.

Discussion of Valuation Methods

Common valuation methods for stocks in the Casino industry are EV/EBITDA and P/FCF. P/E is not as commonly used in gaming stocks because different levels of depreciation expense alter the company values too much. EV/EBITDA is used because of the asset intensity of the business, and the differing depreciation levels of the properties. Free cash flow provides a better estimate of what these companies are capable of. One problem with these valuation methods is that it ignores the level of capital needed to generate cash.

We undertook a Discounted Cash Flow analysis of Station and found that the stock is overvalued. Because of the consistency in debt exhibited by Station over the past few years, the standard WACC calculation yielded a valuation of $13-14 a share. The movement of cash through time measured in this DCF provides a better valuation than just looking at a simple historic ratio.

[2] UBS Warburg Report on STA, March 21, 2002.

Valuation Method #1: Enterprise value built up from component properties:

Station EBITDA Breakdown (From 10-K)

	2001 EBITDA	EBITDA Margin	EBITDA Multiples	Suggested Enterprise Value
EBITDA	$216,791	23.77%	8.00x	$1,734,328
Averages of various sales multiples for 1999-2001			Less Debt	-1,237,090
Las Vegas Multiples	8.33x			$497,238
EBITDA over 50MM	5.90x		/# of shares	57,700
EBITDA 10-40MM	6.37x		**Implied Share Price**	**$8.62**
Midwest Multiples	5.43x			

Source: Morgan Stanley

Although located in Las Vegas, all Station properties are off the Strip. We felt generous using a multiple of 8.00x, especially considering that similar sized and higher EBITDA properties in less competitive environments have a lower multiple

Valuation Method #2: Deriving the EBITDA multiple from the market capitalization.

Share Price 4/18/02 x	Shares Outstanding	=Market Capitalization	Add Debt	Enterprise Value	EBITDA	Enterprise Multiple
$18.55	57,700	$1,070,335	1,237,090	$2,307, 425	$216,791	**10.64x**
$8.00	Notional lower limit			$ 1,698,690		**7.84x**
$10.00	Notional upper limit			$ 1,814,090		**8.37x**

Valuation Method #3: WACC

	Actual			Expected						
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenues	**942,469**	**991,678**	**912,177**	**948,664**	**986,611**	**1,026,075**	**1,067,118**	**1,109,803**	**1,143,097**	**1,177,390**
Operating Expenses	**913,598**	**748,866**	**771,338**	**787,391**	**799,155**	**810,599**	**843,023**	**876,744**	**903,047**	**930,138**
EBITDA	**102,194**	**309,137**	**216,791**	**233,354**	**256,519**	**287,301**	**298,793**	**310,745**	**320,067**	**329,669**
Depreciation & Amortization	73,323	66,325	75,952	72,081	69,063	71,825	74,698	77,686	80,017	82,417
EBIT	**28,871**	**242,812**	**140,839**	**161,273**	**187,456**	**215,476**	**224,095**	**233,059**	**240,050**	**247,252**
Taxes	(14,929)	54,098	15,550	54,833	63,735	73,262	76,192	79,240	81,617	84,066
Interest Expense	84,618	94,098	97,142	85,380	88,795	92,347	96,041	99,882	102,879	105,965
N.I. Before Ex. Items	**-40,822**	**94,614**	**28,147**	**21,060**	**34,927**	**49,869**	**51,865**	**53,940**	**55,560**	**57,227**
Ex. Items	-10,653	-546	-8,276	-8,607	-8,951	-9,309	-9,682	-10,069	-10,371	-10,682
Net Income	**-51,475**	**94,068**	**19,871**	**12,453**	**25,976**	**40,560**	**42,183**	**43,871**	**45,188**	**46,545**
NOPLAT	**43,798**	**188,713**	**125,289**	**106,440**	**123,722**	**142,216**	**147,906**	**153,823**	**158,438**	**163,192**
Depreciation	73,323	66,325	75,952	72,081	69,063	71,825	74,698	77,686	80,017	82,417
WC	2,515	188,292	4,227	-	-	-	-	-	-	-
Change in WC	-	185,777	(184,065)	(4,227)	-	-	-	-	-	-
CapEX	-	-	-	94,866	98,661	102,608	106,712	110,980	114,310	117,739
EPS	**$ (0.89)**	**$ 1.63**	**$ 0.34**	**$ 0.22**	**$ 0.45**	**$ 0.70**	**$ 0.73**	**$ 0.76**	**$ 0.78**	**$ 0.81**
FCF	**$117,121**	**$69,261**	**$385,306**	**$87,882**	**$94,124**	**$111,434**	**$115,892**	**$120,529**	**$124,145**	**$127,871**
				$ 81,693	**$ 81,333**	**$ 89,509**	**$ 86,534**	**$ 83,658**	**$ 80,100**	**$ 76,693**

Enterprise Value	$ 2,021,932
Less Debt	$ 1,237,090
Equity Value	$ 784,842
# Shares Outstanding	57,700
Per Share Value	**$ 13.60**
% of Value in T.V.	61%

	Actual			Assumptions						
Revenue - Growth	NM	5.2%	-8.0%	4.0%	4.0%	4.0%	4.0%	4.0%	3.0%	3.0%
Operating Expense = % Sales	96.9%	75.5%	84.6%	83.0%	81.0%	79.0%	79.0%	79.0%	79.0%	79.0%
Depr & Amort. - % of Sales	7.8%	6.7%	8.3%	7.6%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
WC = % of Sales	0.3%	19.0%	0.5%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
CapEx - % of Sales	0.0%	0.0%	0.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Tax Rate (% EBIT)	-51.7%	22.3%	11.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%
Interest Expense (% Sales)	9.0%	9.5%	10.6%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Minority Interest (Income) - % Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Ex. Items (% Sales)	-1.1%	-0.1%	-0.9%	-0.9%	-0.9%	-0.9%	-0.9%	-0.9%	-0.9%	-0.9%

WACC Calculation		Source
Target D/E	3.00	
Effective Tax Rate (5yr Avg.)	34.0%	Yahoo!
Levered Beta	1.00	Yahoo!
Risk Free Rate	4.20%	Ibbotson
Market Risk Premium	6.80%	Ibbotson
Cost of Equity	11.0%	
Cost of Debt	9.75%	10-K
WACC	**7.58%**	
Terminal Growth Rate (Yr)	2.00%	

D/ (D+E)	75%
E/ (D+E)	25%

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