3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Governance and Trading Behaviors Principal Concerns Station Casinos Inc. (NYSE:STN)

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Station Casinos, Inc. is a gaming and entertainment company that owns and operates eight major hotel/casino properties (one of which is 50% owned) and three smaller casino properties (one of which is 50% owned) in the Las Vegas metropolitan area, and also manages a casino for a Native American tribe. It owns and operates Palace Station Hotel & Casino, Boulder Station Hotel & Casino, Texas Station Gambling Hall & Hotel, Sunset Station Hotel & Casino, Santa Fe Station Hotel & Casino, Fiesta Rancho Casino Hotel, Fiesta Henderson Casino Hotel, Wild Wild West Gambling Hall & Hotel and Wildfire Casino. The Company also owns a 50% interest in Green Valley Ranch Station Casino and Barley's Casino & Brewing Company. In addition, Station Casinos manages Thunder Valley Casino in Sacramento, California on behalf of the United Auburn Indian Community.

Summary of 3DAdvisors Findings for STN

- **Governance:** Auditor and director changes and their relationships stand out
- **Governance:** The long list of related-party dealings
- **Governance:** Compensation plans appear excessively lucrative and self-serving
- **Insider Trading:** Declining insider holdings camouflaged by 10b5-1 plans
- **Governance:** Checkered histories of founders still haunt Company
- **Accounting:** Is a recapitalization a foregone conclusion?

Discussion of 3DAdvisors Findings

As our clients are aware, if our research on a company finds indications of anomalous insider trading behavior, we then conduct a review of governance and accounting practices and policies. This second pass at a company to review governance and accounting behavior seeks to identify additional evidence of executive actions that may also suggest underlying or potential problems, which, if found, often provide context and meaning to the trading behavior.

In the case of Station Casino, the second stage of our research revealed a seldom seen level of troubling governance behaviors. In recent years, issues regarding board independence, multiple related-party transactions, and self-serving executive compensation plans stand out and should be of significant concern to investors. Also within the last couple of years, the Company has had three independent auditors and significant turnover in its board membership, including on the audit committee. Meanwhile, it appears that Wall Street has bought into the Company's aggressive growth strategy, despite the colorful and checkered governance behavior and a relatively weak balance sheet, not to mention the noteworthy insider trading and options behavior.

Governance: Auditor and director changes and their relationships stand out

On May 22, 2002, Station switched auditors from Arthur Anderson to Deloitte & Touche. The switch was interesting in that Station's financial statements for the years 2001, 2000 and 1999 we re-audited by Deloitte & Touche, following the dismissal of Arthur Andersen. Such re-audits are often occasioned by a withdrawal of opinions by a previous Auditor or dissatisfaction on the part of a new Auditor with prior years' Audited Financial Statements. No indication is given as whether the re-audits were done at the request of the Company or upon the insistence of the new Auditors. Also no information is disclosed as to whether the re-audits gave rise to any changes or restatements related to the prior years' Financial Statements.

Making this matter ever more interesting is the fact that just over one year later, Station dismissed Deloitte & Touche and, on September 29, 2003, appointed Ernst & Young as its new independent auditor. Rarely do we see such a short tenure as this (outside of Arthur Andersen switches in the wake of Enron) for a major auditor/client relationship.

During the past year, Station made moves to increase the independence of its incestuous board structure but these changes, like its auditor situation, did not come without interesting twists. First, audit committee member **Timothy Poster** resigned, on 6/25/2003. Poster was an original founder of Travelscape, a company where Station president, Lorenzo Fertitta served on the board and owned a 10% stake. We found it curious that Poster's resignation occurred just one month after his re-election to the board. The reason given for his resignation was that a company controlled by Poster was buying the Golden Nugget Hotel-Casinos in downtown Las Vegas, which is not very consistent when one considers the fact that a number of other Station executives (such as Scott Nielson or the Fertitta brothers, see below) are involved with competing interests. Several company insiders have employment agreements that allow involvement with competing businesses.

Poster was replaced by **Lynn Boggs McDonald** who, like Poster, became a member of Station's audit committee. She was a Las Vegas councilwoman and Station made no bones about touting her position which, given her councilperson's status, may have been considered somewhat of a conflict of interest. Frank Fertitta, Station's CEO, said, "her keen understanding of local government will also help us as we continue to expand…." Her acceptance of the board seat was made even more interesting by the fact that she had accepted over $47,000 in campaign contributions from Station and its executives. Within a year, however, McDonald resigned from the Station board, and vacated her council seat, upon her appointment (by the governor) to the Clark County Commission. She said that she had resigned from the Station board so as not to give the appearance of a conflict of interest. It strikes us as odd that she did not consider her councilperson status as a conflict.

In December of 2003, Station removed CFO Glenn Christenson and **Delise Sartini** (the sister of the Fertitta brothers) from the board but kept her husband, Blake Sartini in his position on the board.

Governance: The long list of related-party dealings

Station leases the 27 acres of land, utilized by its Boulder Station casino, from KB Enterprises, a company owned by **Frank J. Fertitta Jr.** and his wife. Fertitta, (see below) is the founder of Station Casino and the father of company Chairman and CEO Frank Fertitta III and company president Lorenzo Fertitta. Frank Fertitta, Station's controversial founder, turned over management and control of Station to his son, Frank III when the company went public in 1993.

Station leases 47 acres of land, on which casino Texas Station is located, from Texas Gambling Hall & Hotel Inc., another company owned by founder Frank Fertitta Jr. Both leases have maximum terms of 65 years.

In 2001, Station sold a wholly owned subsidiary, Southwest Gaming Services (SGS), to Blake L. Sartini. Sartini is the husband of the Fertitta brothers' sister, Delise, who, along with Sartini, served on the Station board at the time. SGS has since been renamed Golden Gaming Inc. Station has sold, and continues to sell, gaming devices to Golden Gaming (about $100,000 worth in 2003).

The Southwest Gaming Services sale, to a related party, prompted a derivative action lawsuit, filed in May of 2003, against the Company and all of its executive officers and directors claiming, among other things, that the terms of the sale were "far less favorable to the company than could be obtained from an independent third party." The suit goes on to charge: "Because of his close familial and business relationships with the director defendants, particularly his brothers-in-law Frank Fertitta III and Lorenzo Fertitta, his wife Delise Sartini and his subordinate officer Glenn Christenson, Blake Sartini received a 'sweetheart deal' on his purchase of Southwest Gaming that would not have been available to an independent third party."

But there's more. In January of 2003, Station bought the Wildfire Casino for $8 million from Bauchman Gaming Ventures (BGV). The two brothers-in-law of Scott Nielson own BGV, Station's chief legal officer. Nielson had an interest in BGV and, one year prior to the purchase, Nielson sold his interest in BGV for $604,713. At the time of the deal, however, Nielson continued to be a co-guarantor of certain of BGV's bank borrowings.

Governance: Compensation plans appear excessively lucrative and self-serving

Station is shifting emphasis from incentive stock options in favor of increasing amounts of restricted stock grants and/or cash compensation. With one minor exception, the Company has not awarded stock options to senior executives since 2001.

The effect of increasing bonus payouts is becoming evident in the corporate expense line, which increased from $7.9 million to $11.5 million in Q1, primarily because of the "change in incentive compensation from a stock option based program to a program which includes cash and restricted stock." These changes mean that the reduction in insider holdings we are seeing are not likely to be reversed in the near to intermediate term.

One of the most interesting components of Station's compensation plans is the Long-Term Stay-On Performance Incentive Plan, which awards certain executives handsomely for nothing more than staying with the Company. Under this plan, Lorenzo Fertitta will receive $1 million in cash in three equal installments each on July 31, 2004, 2007 and 2010 if he remains continuously employed. COO Stephen Cavallaro will get $500,000 in cash on each of June 19, 2005 and June 19, 2008 for the same conditions: remaining continuously employed. Likewise for CFO Christenson, Chief Council Nielson and brother-in-law director Sartini, who received $1 million in restricted shares (valued at the time of the grant) in March of 2001. As of April of 2004, the shares were completely vested and available for sale.

Though we have seen these plans put in place to encourage executive retention after a change in control, this is not the case with Station. Why would they want to leave? Three Station execs are ranked in the top seven of the highest compensated executives in Nevada in 2003. Lorenzo received $1.99 million in salary and deferred bonus in 2003 (without a payout from the above plan). Cavallaro got $1.28 million in '03 and Christenson $1.1 million. The plan seems simply to exist to get more compensation into the pockets of key insiders.

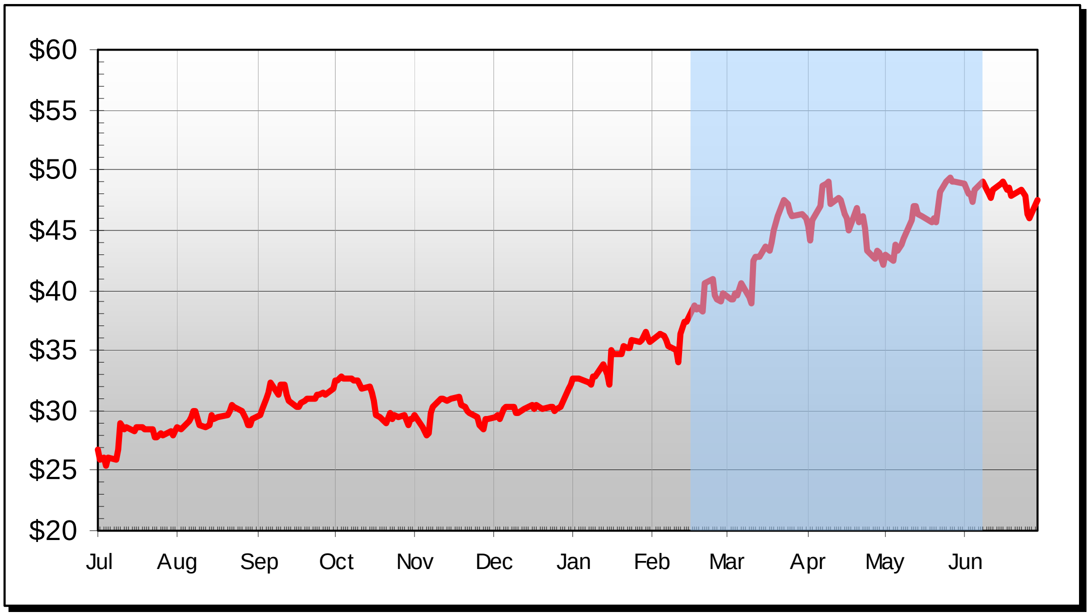
More revealing detail regarding the compensation game at Station lies in the employment agreements of key executives. The group's employment agreements were all entered into on May 20, 2003 and terminate on May 20, 2008 and are subject to automatic 5 year extensions unless the Company or the officer gives notice at least one year prior to the end of the term. Frank and Lorenzo Fertitta's agreements do not prohibit them from engaging in any business or assisting any other entity in competition with the Company during the term of their employment or any time thereafter. General Counsel Scott Nielson is allowed to tend to certain outside interests including two gaming ventures, one of which ultimately sold an interest, Wildfire Casino, to Station (see above).

Insider Trading: Declining insider holdings camouflaged by 10b5-1 plans

Insider distribution is having a significant effect on insider holdings at Station. From March 1st through June 22nd seven insiders sold 2,647,311 shares between $38.51 and $49.75, and this is just the tip of the iceberg: Total annual sales have increased sequentially since 2001, when insiders sold less than 900,000 shares. This year alone, sales through June 2004 have reached 4.4 million shares.

The establishment of 10b5-1 trading plans, which each of the current sellers implemented late last year, provides camouflage for the increased selling volume. In Station's case, however, the use of these plans has gone far beyond their implied intent of orderly diversification. Our judgment is that insiders have exploited these trading plans to unload large quantities of stock, but are finding cover behind what they feel is

Figure 1. STN Stock Chart, July 14, 2003 Through July 12, 2004. Blue shaded area is the period where insiders sold 2.6 million shares. Sources: Reuters and Vickers.



fair divulgence of the activity. In contrast to most companies that utilize pre-arranged trading plans, Station reports the specifications of each plan in an 8-K filing. However, their disclosure fails to mention that while a plan is established with a fixed period of time for the insiders to sell the authorized allotment of shares, most have sold the shares far ahead of schedule. Of the eight plans that ended by April, five were terminated ahead of schedule by an average of three months (the average plan life was six months) because insiders exhausted their allotment.

What's more, each of these Station insiders has immediately established a new, more aggressive plan so that their selling can continue uninterrupted. In nearly each instance, execs have increased the authorized allotment of shares they can sell under the new plan. For example, Chairman, CEO **Frank Fertitta's** January through June plan allowed him to sell 775,000 shares, which he increased to 1.25 million shares in the April through October plan. Executive V.P., Chief Legal Officer **Scott Nielson's** February to May plan authorized the sale of 50,000 shares, but his new April to October plan gives him the ability to sell 150,000 shares. So we have a situation here where selling under 10b5-1 plans is being inferred as benign but in reality, is becoming progressively more aggressive as time goes on. Finally, they waste little time in selling the shares – most make their first trade on the plan's commencement date. Section 16 legal experts usually recommend waiting for a period of time, after filing a 10b5 plan, before selling shares.

- **Glenn Christenson (54)** – Executive V.P., CFO. Christenson has been with the Company since 1989, but it wasn't until 2003 that we saw a spike in his selling. Since last year, he has sold 934,124 shares, considerably more than the 149,200 shares sold between 1997 and 2002. Recently, he sold 135,000 shares of common stock between April 21st and June 15th from $48.06 to $49.22, amounting to a **43% reduction** since the beginning of the year. Christenson's recent selling is part of his second10b5-1 trading plan he entered into in April and lasts through October. His first trading plan was filed in August of 2003 and since that time, he has reduced his holdings from 1.16 million shares to 369,416 shares, a 68% reduction.

- **Scott Nielson (46)** – Executive V.P., Chief Legal Officer. Nielson is currently trading under his third 10b5-1 plan since November after having sold all the authorized shares in the prior two plans. His selling volume hasn't changed from plan to plan, but he has definitely used the cover of the 10b5-1 rule to increase his annual selling from earlier levels. Between 2000 and 2003, the thirteen-year Company vet sold 189,708 shares, which he has nearly matched halfway through this year. Since January Nielson has sold 175,136 shares, with 95,136 shares of that total being sold between March 1st and June 7th from $38.51 to $49.15. Following this round of selling Nielson owns 745,139 shares.

- **William Warner (39)** – Executive V.P., Chief Development Officer. Unlike Nielson, Warner initiated a new 10b5-1 trading plan that appears to have significantly increased the number of shares he is authorized to sell each month. Under the former plan, which had a term from January 2004 to January 2005, Warner sold 30,000 shares per month in March and April. He then entered into a new plan in late April and is now selling 90,000 shares per month. Warner sold all authorized shares in the first plan ten months ahead of schedule. This increased aggressiveness is interesting because he has the smallest actionable position of all executives listed in the Proxy. Since January he has sold 236,100 shares (he had only sold 194,635 shares between 2000 and 2003), **reducing his holdings by 78%**.

- **Frank Fertitta (42)** – Chairman, CEO. Fertitta has been in the senior management ranks since 1985 and is the Company's largest shareholder. His selling has always been rather heavy, but has dramatically intensified over the past few years. In 2001 he sold a total of 192,416 shares and has successively increased his volume each year after. His 2004 sales have already reached 2.1 million shares, which include the 910,000 shares he sold between March 1st and June 14th, grossing $42.4 million. Fertitta's activity has swelled since he entered into his first 10b5-1 trading plan last November. He is currently employing his third plan (term: April 2004 through October 2004) and has increased his selling volume from plan to plan. The sales have trimmed his ownership stake by 40% since February 2002.

- **Lorenzo Fertitta (35)** – Vice Chairman, President. Like his brother Frank, Lorenzo has been an active seller over the past five years. This year we've seen a surge in his volume – he sold 390,500 in 2003 and has already sold 812,000 in 2004. After selling the approved 134,100 shares in his November 2003 to January 2004 plan, he dramatically increased his available shares to sell (1.55 million shares) in the ensuing plan. Most recently, Fertitta sold 735,000 shares between April 21st and June 22nd and grossed $36.3 million. Fertitta, a board member since 1991, sold the shares out of his family trust. After the sales he still has an actionable position of 5.2 million shares.

- In addition to the above-mentioned sellers, Executive V.P. **Stephen Cavallaro** sold 8,515 shares on May 21st at $49. Cavallaro has sold 188,515 shares since January, equal to **46% of his actionable position**. Also selling was Director **Blake**

Sartini, who resigned from his management position in 2001 (and was actually replaced by Cavallaro). Between April 21st and June 14th Sartini exercised five series of non-expiring options (expiration dates: 5/06, 9/07, 12/08, 12/09, 3/11) to acquire 606,560 shares, then monetized the position under a 10b5-1 plan, grossing $29.7 million. The trading plan authorizes the sale of up to 1.36 million shares between April and November.

Governance: Checkered histories of founders still haunt Company

Station's checkered past haunts it today, and it begins with the activities of company founder Frank Fertitta Jr. who, with his partner **Carl Thomas**, began what became Station Casinos with the purchase of a small casino off the Las Vegas Strip in 1976. The casino was named Palace Station. Both Thomas and Fertitta had worked together in a larger gambling operation (Argent Corp.) where Thomas, it was alleged, and others conspired to skim cash from the Argent-owned casinos. A trial ensued in 1985 where Thomas, who was then serving a 15-year sentence for another skimming conviction, testified against his former partners, a dozen of whom where convicted. Though Frank Fertitta was not among those convicted (he was never indicted or charged) some witnesses had testified that Fertitta had been involved in the skimming.

Fertitta stepped down as board chairman in 1993, when Station went public. When Station applied to run riverboat casinos in Indiana and Missouri, however, the skimming case came up again. The mayor of St. Charles, Missouri was quoted as saying "As far as St. Charles riverboat gambling is concerned, we want to know not only about Frank Fertitta III, but his father and Palace Station as well." Station ended up winning Missouri gambling licenses in both St. Charles and Kansas City, with the understanding that Frank Fertitta Jr. would have no role in the Company's operations.

A string of violations in Missouri followed, capped off by an investigation into dealings between Station and a St. Louis attorney, **Michael Lazaroff**, who Station had retained when it first considered moving into the state. Lazaroff pled guilty to, among other things, taking $500,000 in bonuses from Station and not turning them over to his law firm. During the process, Lazaroff testified that he had used his personal relationship with the former gambling commission chairman to increase Station's chances of getting its Kansas City license and that Station officials knew about it. Station officials refused to testify at the commission's public hearings, despite subpoenas. Consequently, Station, and its top executives, were stripped of their Missouri licenses and agreed to pay a $1 million fine.

Problems of this nature have not been limited to Missouri. In 2000, the company paid a $475,000 fine to the Nevada Gaming Control Board for failing to supervise one of its executives who had authorized the printing and distribution of an anonymous campaign mailing designed to discredit a candidate for Clark County (Las Vegas) Commissioner who had, after taking a $40,000 contribution from Station, voted contrary to Station's interests with regards to a proposed project. It's interesting to note that the short board, and audit committee, tenure of Lynette Boggs-McDonald ended with her appointment to the same commission.

In April of 2003, Station became aware of "violations of certain gaming regulations regarding the reporting of certain cash transactions." Station reported the violations to the Nevada State Gaming Control Board. The current investigation concerning this is expected to conclude sometime in 2004.

Accounting: Is a recapitalization a foregone conclusion?

With almost $1.2 billion in long-term debt vs. just $340 million in Shareholder's Equity, financing opportunities appear quite limited and at odds with the Company's aggressive growth plans. With its heavy debt load, Station finds itself hampered by complex covenants tied to its financings. Perhaps the most interesting one is the off-balance sheet $48.8 million "make-well" agreement with regard to Station's Green Valley Ranch Station Casino. The make-well agreement states that if Green Valley Ranch fails to comply with its Fixed Charge Coverage or Leverage Ratios (as defined in the Green Valley Ranch Station credit agreement), Station and its 50% partner will be required to make **cash equity contributions** that will bring it into compliance with its covenants on a pro forma basis. Though it appears that compliance with the covenants is not an issue at this time, the very existence of this make-well agreement speaks to Station's financial condition and how it affects its related financing options.

In the first quarter, cash flow and possibly income as well, (the latter is not disclosed), received a $4.4 million non operating boost from the cash surrender value of premiums paid on terminated life insurance agreements. The Company does not disclose the reason for termination of the life insurance agreements.

Our review of the Company's development and growth plans, along with various other commitments, demonstrates a significant need for cash in the near term. Operating results and cash flows in recent years do not appear to support the growth and development plans without additional debt financing or equity infusions. Despite the Company's optimistic outlook for operating results and cash flows, the present capitalization structure may provide limited access to capital markets in the near term.