Alliance Gaming Corp. (AGI)

1/20/04

Summary:

- Negative changes in the cash conversion cycle raises a red flag in light of recent earnings growth
- Growing risk due to increased vendor financing extended to customers
- Cash flow from operations for the first fiscal quarter of 2004 (ending September 30, 2003) were reported as positive due to a misclassification and should be negative
- Inefficient integration of recent acquisitions
- Board member compensation creates potential conflicts of interest

AGI: $23.93
52-Week High / Low: $27.44 / $12.80
Market Cap: $1.2 Billion
Shares Out: 50.25 million
Float: 47.50 million
% Float Short (11/03): 5.99%
Revenue (LTM): $443.0 million
Net Income (LTM): $26.2 million
FYE: June 30
Auditors: Deloitte & Touche

Company Description:
Alliance Gaming Corporation is a diversified, worldwide gaming company that designs, manufactures and distributes gaming machines and computerized monitoring systems for gaming machines.

Highlight

Alliance Gaming Corporation (Alliance) is one of the market leaders[1] in an industry experiencing positive fundamental trends. Metrics related to revenue and earnings growth, cash flow and working capital all show strength in Alliance's core business. However, we believe there are additional risks due to trends in the Company's cash conversion cycle over the past two fiscal years. We also point out seemingly misleading accounting for operating cash flow, growing risks from sales involving financing, evidence of poor acquisition integration and potential conflicts of interest on Alliance's board of directors. AGI shares currently trade at a discount compared to Alliance's peers, yet in light of the issues addressed in this report, we believe investors should remain cautious on AGI shares due to these unique risks.

Analysis

Cash Conversion Cycle

We believe that trends in the cash conversion cycle (an increase of 61.8% since the second quarter of fiscal year 2002 ending December 31, 2001) in relation to Alliance's peer group (a decrease of 19.2%) are worth investor attention. Much of the volatility in this measurement has occurred over the last three fiscal quarters for all three components of cash conversion. We advise investors to question the underlying factors causing the deterioration of collections. In most cases, the divestiture of unwanted operations would be cause for an improvement in cash collections and a more efficient use of assets. Inventory and accounts/notes receivable for discontinued operations are now held as assets available for sale and no longer count towards DSO or DOH metrics. Thus, we find Alliance's increasing DSO and DOH metrics puzzling, particularly the timing of the increases in relation to the Company's divestitures of discontinued operations.

Table 1 shows Alliance's cash conversion cycle (along with its component parts) versus the Company's peer group. Alliance has been able to partially offset rising days-sales-outstanding (DSOs) and days-of-inventory-on-hand (DOHs) by selling receivables as described below and by extending the length of time it takes to pay vendors (expressed as days-payables-outstanding or DPOs).

[1] Alliance ranks second out of four comparable companies in its peer group in terms of total revenue, market value and return on equity. (Source: FactSet, as of last fiscal year end) Comparable companies used for evaluation include International Gaming Technology, Mikohn Gaming, Shuffle Master and WMS Industries.

Table 1: Cash Conversion Cycle

in days	12/2001	03/2002	06/2002	09/2002	12/2002	03/2003	06/2003	09/2003	12/2003	% Change
Alliance Gaming Corp.										
DSOs	53	52	53	59	54	52	82	85	87	62.8%
DOHs	40	43	55	46	35	37	58	67	80	99.6%
DPOs	(20)	(18)	(19)	(16)	(13)	(18)	(36)	(46)	(48)	141.2%
Cash Conversion Cycle	73	77	89	89	76	71	104	106	119	61.8%
Peer Group										
DSOs	67	69	58	52	54	60	54	59	NA	-11.5%
DOHs	119	122	104	86	89	88	87	91	NA	-22.9%
DPOs	(68)	(63)	(61)	(56)	(56)	(53)	(55)	(55)	NA	-18.1%
Cash Conversion Cycle	118	128	101	82	87	95	86	95	NA	-19.2%

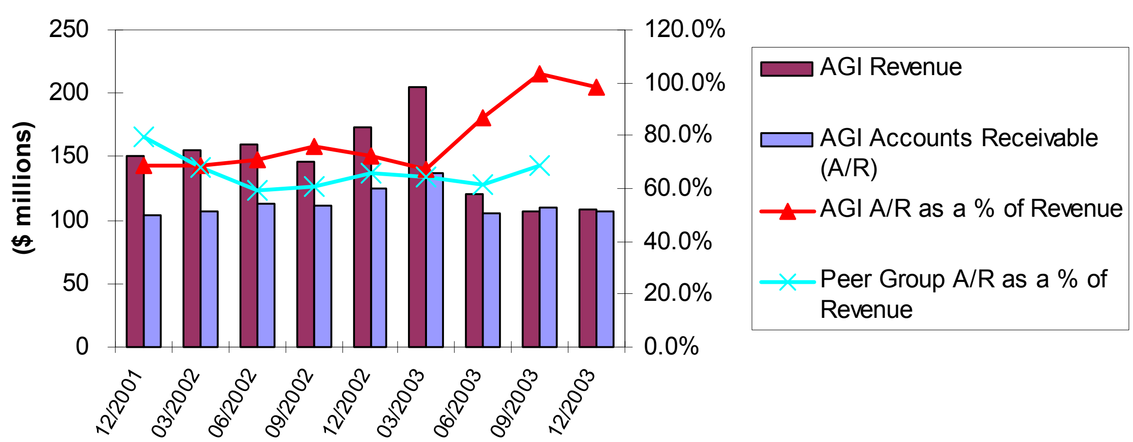
Source: Company Reports, GLC.
Note: Peer Group comprised of IGT, MIKN, SHFL and WMS.
NA = Not Available.

Investors would be well served to monitor the DSO metric over the coming quarters to determine whether this deterioration in collections is the beginning of a persistent trend or an aberration related to divesting unwanted operations.

Changes in accounts and notes receivable are the main contributors to the change in cash conversion cycle. We find two interesting, yet inexplicable trends, in accounts receivable – an increase in the ratio of accounts receivable as a percentage of revenue and the timing of this increase coincides with the decision to discontinue certain operations.

Alliance's accounts receivable, as a percentage of quarterly revenue, has gone from 69% to 103% over the last eight quarters. Over the same eight quarters, Alliance's peer group has seen the same metric move from 67% to 60%. Chart 1 shows the relationship of accounts receivable to revenue for both Alliance and a gaming peer group.

Chart 1: Accounts Receivable Trends for Alliance and Peer Group



Source: Company Reports, GLC.
Note: Peer Group comprised of IGT, MIKN, SHFL and WMS. Data for December quarter not available as of report date.

In addition, Alliance sold a portion of their receivables to a third party financing company in the fiscal year ending June of 2003. We found the disclosure in the Company's June 30, 2003 Form 10-K insufficient, as it did not state the amount of receivables sold. The sale of receivables lowers the balance of accounts/notes receivable, thus lowering the accounts receivable-to-revenue and DSO metrics. In light of our concern regarding the level of these metrics, we find it curious that the amount of receivables sold is not disclosed.

Financed Sales

We believe investors should closely monitor Alliance's increasing dependence on supplying long-term financing to their customers to support revenue growth. Fiscal 2003 saw a trend towards more financed sales, which the Company believes will continue.[2] This makes sense in light of the desire to gain market share – offer potential customers the ability to buy products while delaying payment.

Alliance is offering vendor financing in much the same way that Lucent Technology (LU) did throughout the bubble years for telecom equipment stocks. While Alliance discloses the notes they have extended to customers are all performing within the lending terms, increasing vendor financing does add additional risk for investors. In addition, it is acceptable to record the revenues from these sales only so long as the collection of these long-term (3-4 year) notes receivable is assured as of the date of the equipment sales.

Increased sales involving financing have introduced a growing amount of non-current notes receivable. Table 2 shows Alliance's non-current notes receivable for the past three fiscal years along side non-current notes receivable for IGT and WMS, the Company's two closest competitors.

Table 2: Non-current Notes Receivable

$ in millions	**2001**	**2002**	**2003**	**% Change 2001-2003**
Alliance Gaming	$ 1.433	$ 2.389	$ 14.865	937.3%
International Game Technology	90.606	138.279	145.120	60.2%
WMS Industries	5.637	0.800	2.038	-63.8%

Source: Company Reports, GLC.

Investors should continue to monitor the percentage of revenues related to financed sales and the performance of the notes associated with these sales as they could potentially increase risk in Alliance's revenue trends and receivables.

Operating Cash Flow

We believe Alliance overstated operating cash flow by $5 million in the quarter ending September 30, 2003.[3] Alliance reported the premium payment associated with refinancing the Company's subordinated debt as a cash flow from financing instead of properly subtracting it from cash flow from operations in accordance with Generally Accepted Accounting Principles (GAAP). GAAP requires interest payments (including premiums and discounts from early extinguishment of debt) to be classified as operating cash outflow.[4] As a result, we believe Alliance's reported $5.0 million in cash *generated* from operating activities should be $0.047 million *used* in operating activities.

Table 3 illustrates the cash flow from operations as reported by Alliance with our adjustment to arrive at the pro forma operating cash outflow that includes what we consider to be the proper classification of these charges.

[2] Alliance June 30, 2003 Form 10-K. "Management believes that customer financing terms and leasing have become an increasingly important competitive factor for the Bally Gaming and Systems business units."

[3] Alliance's January 15, 2004 Form 8-K indicates that this treatment is still overstating operating cash flow for the six month period ending December 31, 2004.

[4] Statement of Financial Account Standard Number 95: *Statement of Cash Flows*, paragraph 23-section d. Treatment of premiums and discounts addressed in APB Opinion Number 21, paragraph 15.

Table 3: Alliance Operating Cash Flow

$ in millions	**Three months ending September 30, 2003**
Net Income	$ 6.028
Adjustments to operating cash flow - as reported*	(1.075)
Net cash provided by operating activities - as reported	**4.953**
Premium paid on redemption of subordinated debt**	(5.000)
Adjusted net cash used by operating activities - as corrected	**$ (0.047)**

Source: Company Reports, GLC.
*Net adjustments to reconcile net income to net cash provided by operating activities of continuing operations and net changes in operating assets and liabilities – as reported in the September 30, 2003 Form 10-K.
**Bonds were redeemed at 103.33% of par, which equated to a $5 million premium that should have been classified as an operating cash outflow as the premium represents additional interest costs.

Return on Acquisitions

Alliance is the second largest player in the casino equipment industry behind International Game Technology (IGT) (see Table 4). Maintaining market share in domestic markets and growing share in emerging markets is an important aspect of Alliance's growth strategy[5] and, based on revenue growth over the past two years, it has been relatively successful on this front.

Part of Alliance's growth has been generated from strategic acquisitions in the Gaming Equipment and Systems segment.[6] This segment has seen revenue growth of 38.5% in fiscal 2002 and 49.9% in fiscal 2003. A portion of these gains is attributable to acquisitions, but the specific amount is difficult to determine from Alliance's disclosures. Advanced Casino Systems Corporation had a revenue run rate of $36 million in fiscal 2001 (the year prior to the acquisition) as disclosed in Alliance's March 19, 2002 Form 8-K. Beyond this disclosure we could find no information on the amount of revenue contributed by Alliance's four other acquisitions. There are no references to the revenue contribution of the acquisitions in the Management's Discussion and Analysis sections of Forms 10-K or 10-Q, nor in any reference in the Form 8-K releases related to the acquisitions. The result of which, in addition to being about as transparent as a murky fishbowl, is that the Company's lack of disclosure regarding the revenue contribution of their acquisitions is probably insufficient according to the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB).[7]

While these acquisitions appear to have boosted revenue, they have also boosted debt and have yet to provide Alliance with net income margin similar to that of IGT. Furthermore, SG&A expense has ballooned as a result, growing $38.3 million, or 63.1%, in the last two fiscal years.[8] Table 4 depicts revenue growth, gross margin and SG&A expense as a percentage of revenue for quarters ending December 31, 2001 through December 31, 2003.

[5] Alliance June 30, 2003 Form 10-K - "Competition among gaming product manufacturers, particularly with respect to sales of gaming machines into new and emerging markets, is vigorous. The competition is based on which machines generate the most net win to the casinos, competitive customer pricing and financing terms, quality of the product and having an extensive distribution, sales and support network."

[6] Acquisitions over the last two fiscal years include (2002) Casino Marketplace, Advanced Casino Systems Corporation and (2003) Casino Management Systems, Micro Clever Consulting Systems and Honeyframe Systems in addition to recently (January 7, 2004) announced Crown Gaming in the UK.

[7] Financial Accounting Statement No. 141: *Business Combinations*, paragraph 54 and SEC Regulation S-K item 303(a)(3)(i), instruction 4 regarding Management's Discussion and Analysis (MD&A). The SEC's MD&A rules require disclosure of known trends affecting the revenue line; if acquisitions were contributing in a material way to revenue growth, that trend would be required to be disclosed.

[8] Alliance June 30, 2003 Form 10-K, Management's Discussion and Analysis, "The overall selling, general and administrative expenses increased 37% for the year-to-date period, resulting from the additional headcount added from acquisitions."

Table 4: Trends in Revenue, Gross Margin and SG&A

$ in millions	12/2001	03/2002	06/2002	09/2002	12/2002	03/2003	06/2003	09/2003	12/2003
Gaming equipment and systems									
Revenue	$ 51.631	$ 57.519	$ 68.710	$ 63.539	$ 86.627	$ 82.341	$ 102.929	$ 88.468	$ 96.319
Quarter over quarter change	*14.3%*	*11.4%*	*19.5%*	*-7.5%*	*36.3%*	*-4.9%*	*25.0%*	*-14.0%*	*8.9%*
Gross margin	55.8%	57.8%	53.4%	58.7%	54.2%	58.4%	57.1%	62.4%	59.7%
Casino operations									
Revenue	17.607	19.001	17.584	17.790	16.778	19.357	18.199	18.136	12.312
Quarter over quarter change	*-3.1%*	*7.9%*	*-7.5%*	*1.2%*	*-5.7%*	*15.4%*	*-6.0%*	*-0.3%*	*-32.1%*
Gross margin	55.3%	57.3%	55.1%	54.0%	51.9%	51.3%	55.8%	56.0%	60.3%
Other revenue	81.226	78.312	72.711	65.403	70.221	73.757	-	-	-
Total Revenue	150.46	154.83	159.01	146.73	173.63	175.46	121.13	106.60	108.63
SG&A Expense	30.922	30.292	31.745	29.416	31.124	35.356	29.189	30.015	24.248
Quarter over quarter change	*21.0%*	*-2.0%*	*4.8%*	*-7.3%*	*5.8%*	*13.6%**	*-17.4%*	*2.8%*	*-19.2%*
SG&A expense as a % of revenue	20.6%	19.6%	20.0%	20.0%	17.9%	20.2%	24.1%	28.2%	22.3%

Source: Company Reports, GLC.
*Increase due to acquisitions in the Gaming Equipment and Systems segment, partially offset by reductions in other segments as stated in Alliance's March 31, 2003 Form 10-Q.

Table 5 shows higher SG&A spending as a percentage of revenue and a lower net income margin compared to IGT. We believe that Alliance's lower margins and higher SG&A expense may result from difficulty in eliminating duplicative costs and redundancies created through acquisitions (although this trend does seem to be improving in the most recent quarter). Table 5 also illustrates the higher degree of leverage at Alliance compared to the gaming peer group.[9]

Table 5: Industry Comparison

$ in millions, except %s and Debt/Equity ratio	International Game Technology	Alliance Gaming	WMS Industries	Shuffle Master
Market capitalization	$ 12,235.94	$ 1,241.13	$ 807.86	$ 603.70
Revenue - last fiscal year	2128.137	407.560	178.726	56.128
Year over year growth	*23.1%*	*37.7%*	*2.3%*	*17.0%*
Gross margin	51.4%	56.6%	59.1%	75.4%
R&D as a % of revenue	4.5%	4.9%	22.5%	12.2%
SG&A expense	272.151	99.071	56.225	14.748
SG&A as a % of revenue	12.8%	24.3%	31.5%	26.3%
Net income margin	18.4%	9.9%	-4.6%	25.0%
Operating cash flow to revenue	20.2%	10.8%	11.2%	33.8%
Debt/Equity	0.9	3.8	0.5	0.0

SG&A expense at Alliance is almost double that of the market leader but is in-line with or above the next two companies.

Alliance has a much higher debt/equity ratio than the rest of the peer group.

Source: Company Reports, GLC.
Note: Fiscal year ends are as follows: IGT – September 30, 2003, Alliance – June 30, 2003, WMS – June 30, 2003, Shuffle Master – October 31, 2002.

[9] Alliance's January 15, 2004 Form 8-K indicates that SG&A expense as a percentage of revenue has dropped to 22.3% for the quarter ended December 31, 2003 - still higher than IGT. Debt/Equity at Alliance is now 3.4X and net income margin increased to a more competitive 17.3%.

Alliance's gross margin of 56.6%, while higher than IGT, trails that of WMS and Shuffle Master.[10] This, along with its SG&A spending, contributes to Alliance coming in third in terms of the revenue dollars that are turned into bottom line profits.

Monitoring management's progress in reducing expenses related to inefficiencies brought on by acquisitions should allow investors better insight into the Company's overall financial health and ability to support further revenue growth.

Corporate Governance Issues

We believe investors should be interested in the compensation agreements for two Alliance directors. Directors Kirschbaum and DiCesare receive a bonus based on acquisitions made by Alliance of greater than $60 million and new financing arrangements greater than $50 million. For example, the new $400 million credit facility secured by the Company September 11, 2003 would merit a bonus of $1.2 million for both directors if they were involved.[11]

We feel these bonus formulas potentially conflict with the best interest of shareholders as they offer the prospect of inflated purchase prices for acquisitions and new debt with unfavorable financing terms. This bonus formula has been in place since both directors joined the board in 1994. We believe that since the bonus formula is disclosed, Alliance remains in compliance with NYSE listing requirements and SEC rules regarding compensation. However, since new NYSE rules require compensation and nominating committees to be comprised of independent directors[12], both Mr. Kirschbaum and Mr. DiCesare will need to be replaced on these committees.[13]

More information on Alliance's corporate governance, including analysis of the Company's option plan and auditor independence, can be found in our Proxy Paper released in November of 2003.

Valuation

AGI shares trade at a discount to the Company's peer group based on the metrics shown in Table 6. AGI shares currently trade at a 47.1% discount to its peers in terms of forward price to net income ratio, which compares to the average discount of 39.6% over the last five years. We note AGI trades at only a 28.7% discount to its most comparable peer, International Game Technology. The higher degree of financial leverage at Alliance is reflected in the difference in the discounts between price to net income and enterprise value to sales ratios. We also note that the premium to the peer group shown in terms of the price to operating cash flow ratio includes operating cash flow as reported by Alliance and therefore does not include our $5.0 million adjustment detailed above. While AGI shares trade a discount based on several factors, we believe Alliance carries unique risks that warrant investor attention on a go-forward basis.

[10] Alliance's January 15, 2004 Form 8-K indicates that gross margin for the quarter ended December 31, 2003 was 59.8%. Alliance still ranks third in percentage of revenue dollars that are turned into bottom line profits despite the most recent quarter's improvement.
[11] Based on the bonus formula presented in the employment agreement attached as an exhibit to Alliance's June 30, 2003 Form 10-K. Formula for bonus on new financing arrangements is 0.3125% of the value of the financing less $62,500. Credit facility secured on September 11, 2003 was $400 million.
[12] Section 4(a) and 5(a) of the NYSE Corporate Governance Listing Standards Section 303A Final Rules.
[13] Mr. Kirschbaum is on the Alliance board of director's compensation committee and Mr. DiCesare is on the Alliance board of director's nominating committee.

Table 6: Valuation Analysis

As of 1/20/2004	AGI	Average - Comparables	Premium/ Discount
Valuation			
Price / Net Income - LTM	28.8x	35.7x	*-19.3%*
Price / Net Income - FYE +1	32.3x	61.2x	*-47.1%*
Enterprise Value / Sales - LTM	3.6x	4.9x	*-28.0%*
Price / Net Income - 5yr Ave	21.3x	35.3x	*-39.6%*
Price/Operating Cash Flow - LTM	14.6x	11.2x*	*30.4%*
Performance			
Price	23.93		
52-Week High	27.44		
52-Week Low	12.80		
YTD % change	-2.9%	3.1%	

Source: Factset, GLC.
Peer group consists of IGT, MIKN, SHFL and WMS.
*Price/Operating Cash Flow for WMS was not meaningful and therefore removed from the sample.

Conclusion

Alliance Gaming is a market leader in an industry that should benefit from increased interest in gaming due to growing state budget deficits and from the thriving Native American gaming market. However, we believe investors should be aware of the performance of recent acquisitions, a deteriorating cash conversion cycle and misleading accounting that potentially overstates operating cash flow, as well as potential conflicts of interest within Alliance's board of directors. Understanding these issues should allow investors to better know when to hold 'em and know when to fold 'em when it comes to AGI shares.