Street still sour on Great Canadian

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If you take a quick look at Great Canadian Gaming Corp. you'll probably think it's a sure bet.

The gambling outfit has only one formidable competitor, Gateway Casinos Income Fund, in its main territory and regulatory hurdles make it tough for new competitors to emerge. The government provides subsidies and the gambling industry is very profitable.

It would be hard to pick a better business. And investors who got in early have done phenomenally well. In 2001, for example, the stock (GCD/TSX) traded for less than a $1. Up until early 2003, the stock could be bought for less than $4. It now has a 52-week high of $22.40.

But Great Canadian has a lengthy list of recent stumbles. Despite the company's attractive assets -- casinos and racetracks across the country as well as in Washington state -- the Street has lost confidence in the story.

Once even touted as an income trust candidate by analysts, the stock is down 44% from the high of $22.40 in April, 2005. This year, it is down 24% to a close of $12.53 yesterday.

The company, based in Richmond, B.C., has issued two profit warnings in a row, with its president and chief operating officer resigning after the most recent warning. It has flirted with breaching its debt covenants and then it upset the Street with the terms of a private placement that helped ease those debt covenants. Criticism of its accounting also dogs the company.

The outlook dimmed further last week when analysts lowered their forecasts after the fourth-quarter audited results came out. The Street's tempered attitude is reflected in a research note on April 5 from Sprott Securities analyst David McFadgen, who rates the stock at "market perform" with a target price of $16. That target, however, comes with a caveat.

"Although there is a potential return of 30% to our target we are not recommending it until we are more confident the company will meet our estimates, which we believe to be reasonable."

Great Canadian operates six casinos in B.C., four in Washington and two in Nova Scotia. It has two "racinos" -- a combination of a racetrack and a casino -- in Ontario, one in B.C., as well as two racetracks in B.C. where it hopes to add slot machines. There's also a bingo hall in Dawson Creek.

Budget overruns and delayed expansion projects dogged the company in 2005. With four acquisitions and three expansion projects, Great Canadian admits it had difficulty handling its growth.

But while the expansion projects aren't all finished, the company is optimistic they will begin to make a difference soon. The biggest disruption to gaming came at a hotel and casino complex in B.C. (River Rock) and another B.C. gaming facility in Coquitlam. Facelifts at the company's Nova Scotian facilities will be done in July, the company predicted.

"The ramp up period for new casinos is typically 12 to 18 months. This period has just begun for some of our properties. We're confident they can return to the high gaming margins we have historically been able to produce," Great Canadian said during its conference call.

However, the company won't win the Street's favour back easily.

Struggles with debt covenants became apparent earlier this year. "The company anticipates a breach of a financial covenant at March 31, 2006, in the absence of remedial action on or prior to that date," Great Canadian said when it released its unaudited results on March 20.

To ease its debt, Great Canadian recently issued 6.2 million units as part of an $80-million private placement. Ross McLeod, Great Canadian's chief executive, bought $50-million worth of units in the offering, which was done at $12.89. Each unit was comprised of one share and one warrant, giving these unitholders the chance to purchase more shares at $12.89 within two years. The remaining units were sold to three participants, one of which was an institutional investor, the company said.

During the conference call, Mr. McLeod said: "I believe my personal investment in this placement provides evidence of my faith in the company's future."

The terms of the financing, however, caused grumbling on the Street. Highfields Capital Management LP, a U.S. hedge fund that owns about 4% of Great Canadian's outstanding shares, went as far as to write a letter to the Toronto Stock Exchange and ask for an investigation.

It called the private placement "an unnecessary and unjustified transfer of wealth to a corporate insider." The $12.89 unit price didn't consider the value of the warrants, Highfields said. (Most warrant financings usually price the warrants at a premium to the market.) The hedge fund values the units between $15.50 and $17, meaning it believes Mr. McLeod received warrants in the company for free.

TSX responded to the letter by saying that Great Canadian "followed TSX procedures and the matter is closed."

Veritas Investment Research, a Toronto-based independent research firm, also recently weighed in with a negative report on the stock recently, warning, among other things, that the company's accounting practices make earnings appear more attractive than its main a competitor in the short-term.

In a report, analyst **Anthony Scilipoti** explained that gambling outfits in British Columbia have to pay the government a commission, but certain expenses are refunded to the companies after they generate revenue. Great Canadian recognizes future receipts of this refund immediately, **Mr**. **Scilipoti** said.

If Great Canadian used the same accounting method as one of its competitors, Gateway Casinos, its operating expenditures would have been $3-million higher in the third quarter. (Great Canadian reported operating expenditures of $150.8-million in the quarter). EBITDA would have been 5.4% lower, **Mr**. **Scilipoti** calculated.

Mr. **Scilipoti** believes Great Canadian's accounting choices allowed it to stay onside with its EBITDA debt covenants, but he notes that while the company's accounting methods are in accordance with generally accepted accounting principles, it shows how a company can use "the gray areas within GAAP to manage reported financial performance."

Responding to the **Veritas** report, Great Canadian spokesman Howard Blank reiterated that Great Canadian's accounting follows GAAP and added that it doesn't make sense to

compare Great Canadian to Gateway.
"You're comparing apples to oranges. You're comparing an income trust to a non-income trust company."
Sometimes a slumping stock is a good chance for investors to make money on a rebound. But it looks like Great Canadian is a risky bet for this to happen just yet.
"Great Canadian generally said all of the right things in terms of dealing with a difficult situation," TD Newcrest analyst Damir Gunja said in a research note last week while maintaining a "reduce" recommendation.
"However, we believe the reality is the market will continue to wait and judge the company by its actions rather than words given the events of the past year."