

March 05, 2004

### *Where is Multimedia's stock headed?*

Who should be more concerned? An investor shorting a stock he believes should fall that has risen 34% in a five day period when the run-up occurs on significant news that the investor believes has materially impaired the stock's earnings potential. And when the investor believes (based on extensive due diligence) with conviction that the company whose stock is rising has highly irregular accounting that has the effect of turning losses into reported profits and hiding rapidly deteriorating operating results. Or an investor that is holding a former penny stock turned play thing for a group of Wall Street promoters that is trading at an \$800 million market valuation and who knows what multiple? Well, let's take Multimedia Games, Inc. (NASDAQ: MGAM, \$26.43) as an example.

Since last Thursday, Multimedia has experienced two highly material events, both unexpected. These of course are the passage of the new gaming law in Oklahoma and the Department of Justice's loss at the U.S. Supreme Court. Multimedia's short sellers believe they could not have expected better news. The short sellers believe no reasonable and objective analyst could argue any differently. Multimedia has operated without competition from the industry leaders. The leaders were prepared and have entered the market and have far better and far greater resources than Multimedia. This is not the only thing that enticed the short sellers.

Multimedia's accounting is extremely complex. Attached are two tables that illustrate two of the problems with Multimedia's accounting. The first table titled [Table I: Comparison of Change in Earnings and Assets](http://198.170.243.139/report-images/MGAME&A.pdf "Table I: Comparison of Change in Earnings and Assets") compares Multimedia's reported Class II earnings for its most recent quarter ended December 31, 2003 with those of the same quarter last year. Multimedia's core business earned \$1.9 million (15%) less this year than last year. Meanwhile Multimedia's assets increased by \$62.7 million during the period. That is a 66% increase in assets with no accompanying increase in earnings. Assets grow when companies spend money and don't take the expense—thereby inflating their earnings. This leads us to the next table.

We have attached a second table titled [Table II: Annual Analysis of Cost per Installed Machine](http://198.170.243.139/report-images/MGAMCOM.pdf "Table II: Annual Analysis of Cost per Installed Machine"). This table analyzes the amount that Multimedia claims that it spent on its games. Multimedia only provides this information annually. So the table looks at the last three years. During 2003 Multimedia spent \$43.8 million and installed 3,335 additional machines. This equals, according to Multimedia's own disclosures, \$13,124 per machine. This amount is far in excess of the amount anyone can spend to buy a comparable machine. In fact, again according to Multimedia's own disclosures, during 2002 Multimedia added 3,324 machines at a cost of \$24.4 million. This means that Multimedia spent an average of \$7,326 per machine. During 2003 Multimedia claims that it spent \$19.4 million more than it did during 2002 to add machines. Yet it only added 11 more machines. Multimedia's inventory, property and equipment and other asset breakdown disclosures are very poor. But there is no doubt that its assets are inflated and questionable.

There is another important item. Multimedia's historical earnings were generated with "slot-like" machines that regulators forced its customers to replace. Management does not disclose how many machines it has replaced and how

many it still needs to replace. This is not the first time regulators have forced Multimedia's machines to be replaced. Each time the machines were replaced the new machines played more like bingo machines (Class II) and less like slot machines (Class III), and revenues per machine have decline.

So an unbiased investor could agree that Multimedia has questionable accounting and that events have occurred that have adversely impacted Multimedia's ability to duplicate its past performance and its future growth. Yet since last Thursday Multimedia's stock price has risen 33.9%.

Could Multimedia make more money this year with slower regulated machines and greater competition than last year? Not likely. After all Multimedia had no competition from any of the industry leaders and approximately a 60% market share and its 30% take is twice the industry average. Could Multimedia grow faster? Multimedia has been a fringe player in gaming since 1989. It has not been able to compete in Class III gaming. It gained market share by offering Class II gaming before it was regulated. Until now Multimedia has been unopposed. There is no reason to believe Multimedia's Class II business will grow and there are plenty who believe it will decline in revenues, number of machines and margins. Will the Class II market grow and Multimedia with it? Class II gaming is far less profitable than Class III gaming. For now, Indians playing Class II games will not be required to pay the states a percentage of their revenues. In California Class II games are used only when casinos reach the maximum number of Class III games allowed. Multimedia's analysts believed Casino San Pablo in the San Francisco area, which was totally funded by Multimedia, would install 1,500 Class II machines. Not one Class II machine has been installed.

Any investor must be concerned when his company's valuation changes by 34% in just five days. This includes those who bought stock without knowing what Multimedia is all about.

Asensio & Company, Inc. covers Multimedia Games, Inc. and maintains a Strong Sell and Short Sell opinion. A summary of the basis of our opinion is found in our October 2, 2003 report published on [www.asensio.com](http://www.asensio.com).

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