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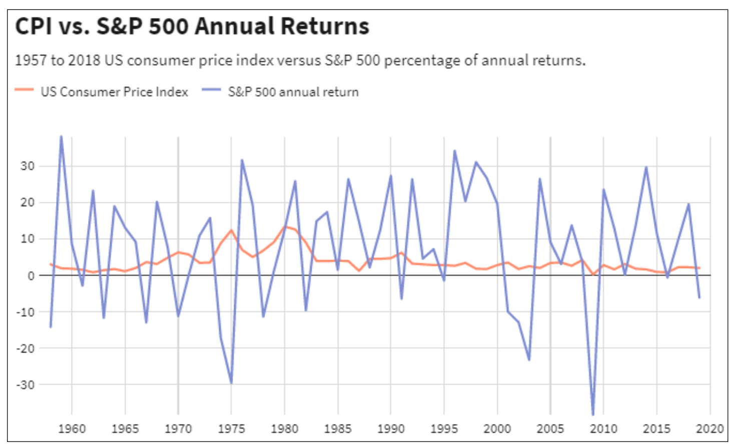
Great Expectations – Why Tribes Need to Revisit Their Thinking About Return on Invested Capital

By Kristi Jackson

We've heard this way too often: "we are only interested in looking at opportunities if they produce returns like our gaming operations . . ."

Comparing new opportunities to the magnitude of success of many gaming operations, leadership is frequently setting the bar for returns at an unrealistic level. Practically speaking, that generally implies high double-digit cash flow returns with payback periods of five years or less. A gaming operation – particularly those located in a less competitive market and with high barriers to entry – should not be the standard by which to judge future economic development opportunities.

An interesting comparison is the oft-quoted average return on the S&P 500 index. Going back to its inception in 1926, the annual average has been roughly 10%. As the chart above highlights, the impact of inflation erodes this average – by at least roughly 3% – to something closer to a 7% real return. Said differently, you have to make at least about 3% annually to keep up with inflation or the real value of your investment actually would decline.



Source: CPI: Bloomberg; S&P: Macrotrends.net

What is also quite illustrative in the chart above is the sheer magnitude of volatility. Trends are tough to forecast and are discerned much more easily in hindsight than actively pinpointing the right time to buy or sell.

As most readers are keenly aware, tribal gaming businesses have offered a long-term steady stream of life-changing cash flows. In many instances, the initial investment was repaid within the first year of operation. Those types of results are nearly impossible to replicate without the unique regulatory bene-

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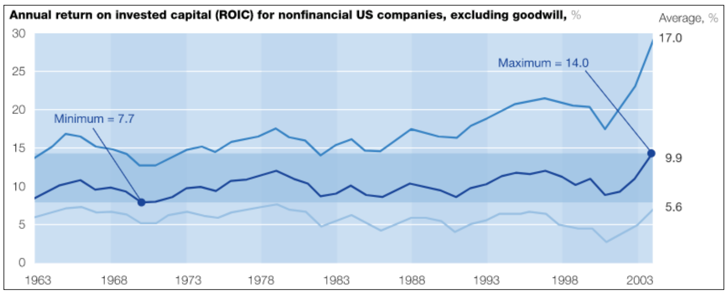
fits Indian Country enjoys within the gaming industry.

So what is a "normal" return? A McKinsey study of the returns on invested capital over a multi-decade period (for publicly traded companies representing over 99% of the revenues of the S&P 500) showed an average return of approximately 10%. Interestingly, this number is similar to the passive portfolio return of the S&P index itself.



Source: McKinsey & Co

The study further identifies returns by industry sector, noting that the industries whose participants often carry patents, brands or other barriers to entry tend to outperform those that are typically less protected. Additionally, capital-intensive industries and those in highly competitive sectors (such as retail) often performed well below the median. Pharmaceuticals, household consumer products and software sectors each produced average returns in the high-teens to low 20 percent range whereas utilities and telecommunications companies were in the single digits. Due to the industry variation, McKinsey notes that "the persistence of differences in ROIC ([Return on Invested Capital]) across sectors suggests that individual companies should be benchmarked against comparable ones operating in similar or adjacent industries." It simply isn't enough to say – I want a mid-teens return. The investor must qualify the expectation of a particular company/investment with the returns of that sector to determine acceptability.

TFA will be attending the following conferences in early October! We look forward to seeing you there!

NAFOA
October 6 – October 8
Prior Lake, MN

global gaming expo G2E
October 14 – October 17
Las Vegas, NV

If you will also be in attendance and would like to set up a meeting, please contact Kristi Jackson at kjackson@tfacp.com

McKinsey also details the variance between the top and worst performers within each sector: "Take the software and services industry…its median ROIC… was 18 percent, but the spread between the top and bottom quartile of companies averaged 31 percent. In fact, the industry's performance was so uneven as to render this metric meaningless." TFA urges tribal governments to exercise caution when evaluating higher returning sectors. Although more "homerun" investments like tribal gaming surely exist, those investments most likely come with significant risk of losing invested capital.

It is much more likely that your next opportunity will be closer to "average" vs another gaming-like performer. Take the time to diligence the fundamentals and compare the investment to its peer group. Beware claims of outsized returns – history has not proven them to be consistently available. Be a skeptic and do your research – if it seems too good to be true it probably is.

Call us anytime to discuss your potential investment opportunity or to help you evaluate it.

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