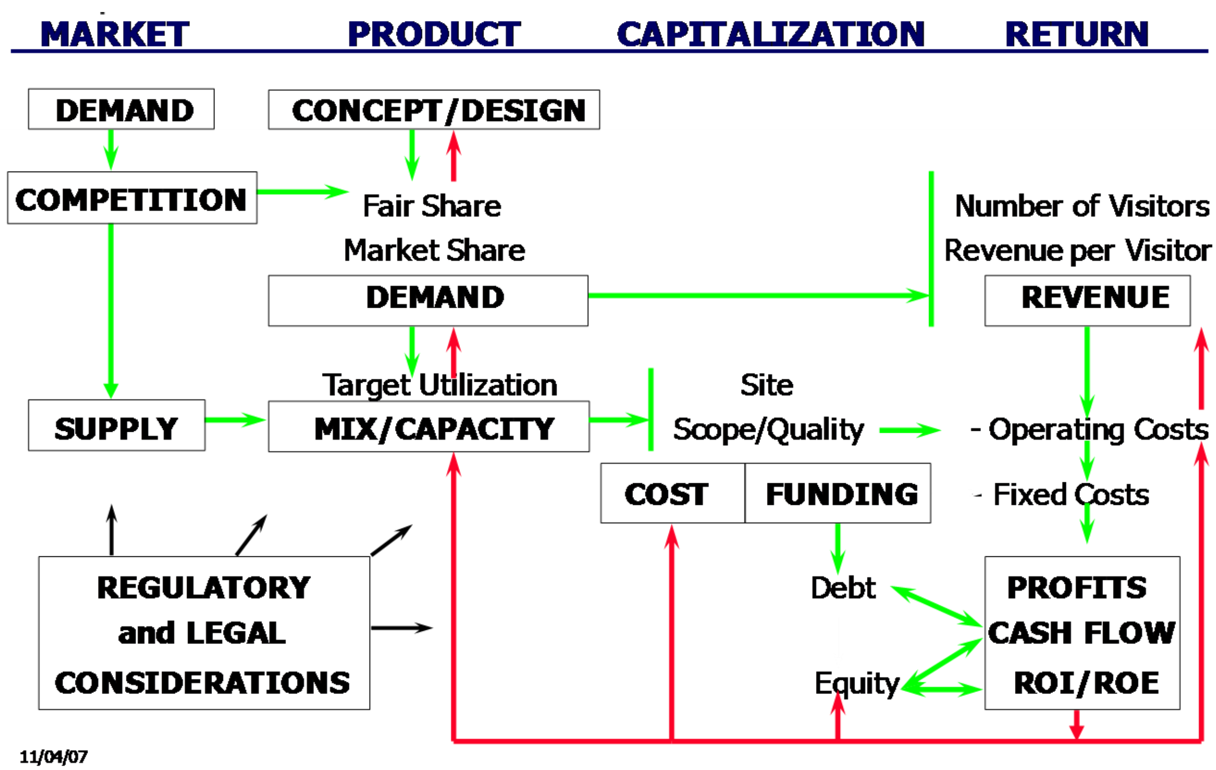
CASINO DEVELOPMENT - PROFIT OPTIMIZATION MODEL

by Dean Macomber 10/19/08



To generate profits, one needs to know how profits are generated.

In kind, to know how profits are generated and to optimize a given profit opportunity, one needs to know what causes and drives profits to occur.

One approach to understand how profit drivers work is to develop a pictorial model that identifies the profit drivers and depicts the cause and effect relationship between and among them ("Profit Model").

The major forces that drive profits may be simplified into four initial categories: (1) the Marketplace, (2) the Product(s), (3) Capitalization (or funding), and (4) Financial Performance. Impacting all of these initial four categories directly and indirectly is a fifth category, Regulatory and Legislative considerations.

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The forces that put profits in motion actually begin far before the player arrives at the casino or, for that matter, before the casino is even built. The start of profitability is vested in the Marketplace, e.g., Where is it? How big is it? Who is it? How many are there? What market segments exist? What is their propensity to gamble? What is their gaming budget? Who is the competition? And, how much supply/capacity is there serving the Marketplace? These factors and other subsets within them determine demand, both "physical demand" (i.e., the number of visitors, hours and days of play) and "financial demand" (i.e., revenue). Using metrics developed from analyses of various existing venues, the maximum demand potential for a given venue may be determined and used as an upside reference point. If the venue is already served by gaming facilities, then historical and current demand can typically be determined using various company, regulatory, government, and/or industry trade magazines in terms of sources of business, aggregate demand, and the current destinations of that demand. Trends can be identified, growth rates determined, and penetration rates understood along with fair share, market share, and percent of fair share ratios used to better understand competitive relationships.

To the Marketplace, a casino developer brings their product ("Product"). One definition of the gaming Product is: an adult, leisure/entertainment gaming related experience. Thus, the Product of gaming is essentially an Experience. This Experience began as primarily a Gaming Experience but has evolved to now include an array of supporting activities (e.g., food, beverage, and entertainment) but also in some cases related activities that can exist as independent profit centers but synergistically contribute to gaming and vice versa (e.g., retail, meetings, conventions, exhibitions, golf, hotel/resort rooms, and condominium sales). The gaming Product comprises any number of tangible and intangible production elements as well as consumer driven consumption elements. Using these elements, it is up to the owner/developer to come up with a vision, concept, programming, and design that aligns with target market segments within the aforementioned Marketplace while at the same time niche-ing and/or beating the competition while meeting or exceeding the financial and non-financial goal set of the stakeholders. Both in isolation and relative to the competition the location, size, quality, concept, price-value, and other project attributes determine how much the gaming facility will capture of existing demand, penetrate more deeply into the existing market, and/or expand demand beyond the current Marketplace boundaries and/or definition.

As the venue concept, programming, and design are being developed at some point the cost of developing such a project must be determined and tested for reasonableness relative to the expected physical and financial demand forecast for the property. Here again, metrics have been developed to determine capacity and the hard (e.g., construction cost) and soft costs (e.g., pre-opening labor and marketing) of developing a project be it a new project, expansion, and/or fine tuning of an existing operation. Once the cost is dialed in, the owner/developer must capitalize or fund the project, typically using a mix of equity and debt each with its own cost of capital, terms, and conditions.

This leads us to the final driver, Financial Performance. Physical and financial demands have already been determined so this step of the model is intended to address efficiency, productivity, and financial return. The first two of these categories deal with being able to bring the optimal amount of revenue to the 'bottom line.' Note that the word "optimal" is intentionally used rather than "maximum" in order to indicate that optimization tends to take more of a holistic look at generating profits, e.g., the cost-benefit of competitive marketing practices, embedding longer versus short term profitability, and risk management. Ultimately, the final arbiter of success is the return the owners and stakeholders receive from their investment. Return for most capitalistic, profit-driven owners' means financial return on investment of which there are many measurements. But, even capitalistic, primarily profit-driven investors may have other non-financial return objectives (e.g., strategic value) and, government (both mainstream local, regional, or national governments as well as Native American, First Nation, or Aboriginal governments) also may add or feel non-financial objectives to their investment return are the most important (e.g., job creation, tourism industry support, new business incubator, and the like).

A typical dynamic prevalent in one form or another in almost all gaming venues today that affects all of these categories above and beyond what has already been presented is the impact of legislation and regulation. The former often establishes such critical parameters as the number of casino licenses that may be issued, what activities may take place, where, and the rate of the gaming revenue tax to name but a few. Regulations and regulators oversee and control who gets licensed and how as well as establishes regulations about how the business will be operated, marketed, and controlled. The intensity of impact legislation and regulation impacts a given operation varies from venue to venue.

Two other macro factors that have the potential to impact profitability (but are not shown in the Profit Model for sake of simplicity of presentation) are External and Internal factors. External factors may include such issues as the impact of the macro economy, political stability, business environment, weather, access/egress, and tourism infrastructure. Internal factors may include the culture, values, and passion of the owner, ability to raise/support capital, and internal organizational strengths and weaknesses.

Lest anyone think a model can be developed only once, it should be recognized that because the Marketplace, competition, and virtually all of the major profit drivers already identified (not to mention innumerable other factors not mentioned) change over time, sometimes evolutionarily but at other times unexpectedly and revolutionarily as well, the Profit Model is best thought of as dynamic not static. Developing a new project or fine tuning one already open is a constant, iterative exercise. This is not just because the Marketplace is constantly changing but also because a decision that affects one element or one category often has the potential to impact other elements or categories. Also, like the Marketplace, a given project is constantly in a state of flux, dynamic not static as well.

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While the Profit Model for a new project most logically flows left to right, top to bottom, reality is that discussion of how to optimize profitability for some new projects (and expansions) may begin elsewhere in the Profit Model. Similarly, profit optimization initiatives of casinos already open and operating may start at various locations in the Profit Model. In both new and open-and-operating facilities, it is not so important where the profit optimization initiatives begin as it is that all of these factors contained in the Profit Model be taken into proper account before the evaluation and decision process is concluded.