TFA CAPITAL PARTNERS

RELATIONSHIPS BUILT UPON
TRUSTED INDEPENDENT ADVICE

TFA Monthly Newsletter

October 2022

Forecasting in an Increasingly Uncertain World

By Braxton Sato

Do you know how much inflation, GDP growth and unemployment were factored into your business' budget for this year? What about next year's budget or your Tribe's 5-year financial forecast? Even the casino business, despite sometimes being considered "recession-proof", is still subject to the ebbs and flows of the economic tide, and the tides are significantly different than most of the world expected a year ago. When macroeconomic conditions are so unpredictable – it is important for decision makers to understand the assumptions embedded in the numbers they rely on, and to direct their teams to update those assumptions as reality unfolds.

Expectation vs. Reality

Inflation is weighing heavily on everyone's mind. Consumers are figuring out how to adjust their spending as real wages continue to shrink. Businesses are having to balance passing cost increases along to customers and/or taking a hit to net profits. Wall Street investors are feeling the impact on their portfolios and have been reallocating their capital to sectors and asset classes that represent "inflation plays ." All while the Federal Reserve is regularly using it's primary tool to curb further inflation - raising interest rates.

All of these groups are dealing with price increases almost no one expected a year ago, including top economists at the Federal Reserve. Looking at the Federal Reserve's own projections published in September 2021 – the range of expected values for 2022 PCE inflation was 1.7% to 3.0%. Core PCE Inflation (excluding food and energy) ranged from 1.9% to 2.8%. Actual values published by the Bureau of Economic Analysis were significantly outside the estimated range (see Figure 1 below).

Figure 1	Projected Range for 2022[1]	Actual August 2022[2]	Actual YTD 2022
Change in real GDP	3.1 - 4.9%	-0.14%	-0.27%
Unemployment Rate	3.0 - 4.0%	3.70%	3.68%
PCE Inflation	1.7 - 3.0%	6.30%	6.39%
Core PCE Inflation	1.9 - 2.8%	4.60%	4.94%
Federal Funds Rate	0.1 - 0.6%	3.0 - 3.25%	1.55 - 1.8%

[1]Projected range for 2022 as of September 2021
[2]Real GDP data is from June 2022, and PCE and Core PCE data is from July 2022, which is most recent available. Federal Funds Rate is from September 21, 2022

Many of the tribes that are reliant on their casinos for funding the government will be particularly vulnerable to inflation. Casinos cannot pass on price increases to the consumer as easily as in other industries, and even a good manager will have trouble keeping expenses under budget in an inflationary environment without sacrificing revenue or quality of service. While anecdotal, we have heard several casinos discuss the need to revise their budgets downward for the 2nd half of 2022 – but not one has mentioned to us an upward forecast revision.

Interest rates are also significantly outside of the Fed's range of expectations from last year. The Federal Reserve on September 21 announced

(continued on Page 2)

IN THE NEWS

Here's your guide to sports betting and everything else to know about gambling in California
9/5/22 – Calmatters.org

Cardroom moratorium extension fails in California senate committee tie vote
9/5/22 – Casino.org

Enormous valuation for the United States' gambling industry
9/14/22 – Worldcasinodirectory.com

TribalNet: Casinos have a lot to learn from other industries
9/14/22 – CDCgaming.com

Why California might become a major hub for a new type of tourism
9/15/22 – Pechanga.net

Arizona Dept. of Gaming reports $41.6 million in contributions
9/21/22 – kyma.com

Two years after Nebraska voters had their say, first casino set to begin netting tax revenue
9/23/22 – Journalstar.com

(continued from Page 1)

they increased the target range for the federal funds rate to "3.0% to 3.25%". In September 2021, the Fed released the "dot plot," each dot representing the interest rate expectations of a member on the committee. As seen in Figure 1 – no one predicted rates would exceed 1%, let alone 3.25%. The September 2022 dot plot looks significantly different than the prior year. This change in interest rate environment is very meaningful to tribal borrowers. If you approved a $100 million capital project a year ago, assuming rates were 1%, and today they are 4%, you would be incurring incremental interest expense of $3 million a year, which would directly impact distributions.

What questions should you be asking?

The point of highlighting these recent misses in forecasting at the highest levels is not to say that forecasting is pointless because people are so often incorrect. It is to promote better understanding of the assumptions driving the numbers. Forecasting is still extremely necessary in business and government, it just requires extra attention in periods of increased volatility – and regular updating.

Here are some questions we typically ask when evaluating budgets and forecasts:

- What is factored into the model (endogenous variables) and what is not (exogenous variables)?
- COVID was an exogenous variable that sent businesses scrambling to redo their forecasts.
- What general economic conditions were assumed in putting together the revenue forecast?
- Does the revenue forecast include any expected changes to the competitive landscape?
- What is the baseline level of inflation assumed in the forecasted costs?
- What is the probability of recession factored into next year's operating forecast?
- Are any black-swan events factored into the forecast on a probability-weighted basis? What are those events, the probability of occurrence, and the magnitude of the impact to the business?

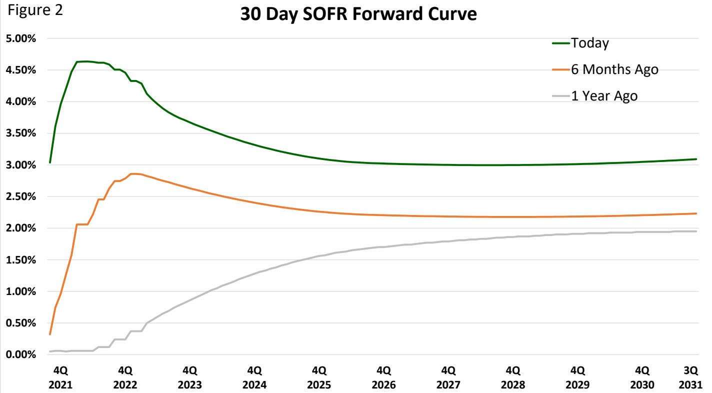
How often should you be updating your forecast?

In an ideal world, forecasts should be updated when any new information comes in. However, this must be balanced against the materiality of the change and the finite resources of the team doing the work. The following situations should warrant a second look at old numbers:

- If actual results or assumptions are significantly above or below forecasted levels
- The occurrence of an event that the forecast thought might happen
- The occurrence of a major black swan event the forecast had not considered
- Interest Rate forward curves should be updated frequently - not just around Fed meetings - especially now that we are no longer in a historically low and stable interest rate environment.
- At the very minimum, management should review projections quarterly and provide leadership with a view if they are still on track for the year.

At TFA – all of our advice is grounded in analytics, and we would be happy to discuss the continued relevance of forecasting in these increasingly uncertain times.

Figure 2



TFA is Excited to Attend the
NAFOA Fall Finance & Tribal Economics Conference
October 3rd – 4th, 2022

We look forward to seeing everyone at our table!

TFA
201 Continental Boulevard
Suite 110
El Segundo, CA 90245
tfacp.com

KRISTI JACKSON
CHAIRMAN
310.341.2335
kjackson@tfacp.com

DAVID HOWARD
CEO
310.341.2795
dhoward@tfacp.com

FOLLOW TFA ON:

WILLIAM NEWBY
PRESIDENT
310.341.2796
wnewby@tfacp.com

WILLIAM CRADER, CFA
MANAGING DIRECTOR
310.341.2336
wcrader@tfacp.com

BRAXTON SATO
VICE PRESIDENT
310.341.2339
bsato@tfacp.com