GEO Group Has A Massive Debt Problem - The Dividend Is Not Safe Under Current Covenants

Refinancing debt is extremely difficult to be achieved under better terms. With many creditors abandoning GEO, those who lend will do so at a premium. GEO's dividend is not safe by any means. A cut should not surprise investors since the company is not allowed to distribute a single cent, should it miss on its debt repayments. The GEO Group (GEO) and CoreCivix (CXW), another prison REIT, are often recommended for their high dividend yield towards retirees and income-oriented investors. In this article, I want to focus on The GEO Group, whose yield is supposedly well-covered by the company's FFOs. What some fail to see, however, is that besides subjective reasonings to whether the stock is worth investing (e.g., ethical reasons), the company has, objectively speaking, a massive debt problem. I believe that the company faces severe financing issues and that should these trigger its debt covenants, investors will see their dividends go down the sink. Debt and some more debt. I have often mentioned that debt accumulation is not necessarily a bad sign for companies. If management can achieve a higher return on equity relative to the cost of debt, it would be doing a disservice to shareholders by not taking-on that extra funds. Since most REITs rely on issuing both debt and equity to finance future acquisitions, debt accumulation is typical. What is the first worrying sign about GEO, however, is that its debt to equity ratio has gone through the roof. While some REITs also share similar ratios, GEO's continuous upward trajectory is the first sign that urges a deeper look into the company's debt situation. Diving inside GEO's latest 10K, I was not surprised to find a huge section, specifically dedicated to the company's debt profile and its potential risks. Listed below, these four senior notes, make-up for around half of the company's debt obligations.

5.875% Senior Notes due 2022 ($250.0 million)
5.125% Senior Notes due 2023 ($300.0 million)
5.875% Senior Notes due 2024 ($250.0 million)
6.00% Senior Notes due 2026 ($350.0 million)

Source: 10K

Since GEO's financial position is not great, to say the least, creditors have added some extra covenants to secure their funds don't go bust. And trust me, they are not light. These covenants are not new; however, GEO's financials have been worsening, and that's what concerns me. The "easy" ones include restrictions towards: transfer and selling assets, make capital expenditures above certain limits, create or permit restrictions on the ability of their subsidiaries to pay dividends to GEO, enter into sale/leaseback transactions If selling assets and restricting GEO subsidiaries -which is where all of the income for the parent GEO, comes from- wasn't enough, we have a couple more constraints. GEO is restricted from: merging or consolidating with another company or selling substantial of its assets issue preferred stock of subsidiaries, then the real killer: Pay dividends, repurchase stock, prepay subordinated indebtedness, make investments and for the cherry on top, Incur additional indebtedness. If the company fails to comply with any of these covenants, creditors are to prevent GEO from being able to draw on the Revolver (what keeps the company afloat and operating), as well as cause a default. Moreover, management mentioned: If all of our outstanding indebtedness were to be accelerated, we likely would not be able to simultaneously satisfy all of our obligations under such indebtedness. Meanwhile, if the company were to refinance its debt, it would run into more problems. To begin with, all publicly known existing banking firms providing lines of credit and term loans to GEO have officially committed to ending ties with them. Any other creditor would ask at least similar debt provisions if not worse. We can argue all we want about the future of private prisons and whether they are going under any time soon. They may survive, or they may not. What we do know, however, is that their future is not one of growth, legislative support, and prosperity. Management is well-aware of these issues and has stated in their annual 10K: ...we may not be able to complete such refinancing on commercially reasonable terms or at all. If for any reason we are
unable to meet our debt service obligations, we would be in default under the terms of the agreements governing our outstanding debt. Investors need to understand that GEO's indebtedness risk is not included in the spirit of a typical risk acknowledgment, as expected inside a standard 10K. The company is indeed tied with huge credit risk and very likely default. A dividend cut is the least investors should be worrying about, as the company could face insolvency. Some may argue that the dividend is "safe" because FFO covers it. That's not entirely true. The company has continuously been had to be repaying more of its debt from what it generates from its cash flow from operations. In the past, it could issue more debt to cover its existing one or even refinance. However, this is now not possible for two reasons: Covenants restrict GEO from taking on additional debt. To refinance the existing one would cause worse restrictions as the socio-political risks of private prisons have only been increasing. Meanwhile, the current FFO payout ratio has been hovering around 90%-110% over the past two years. Even if the company could somehow sustain that, the fact that it can no longer pay its debt obligations with debt, it would have to be from cash flow from operations. In other words, a dividend cut is very probable. Remember that the company is also restricted from selling major assets, as well. The company was, in fact, able to increase its senior credit facility by an additional $450 million, under the same conditions, but this is enough to cover the next two years of dividends, barely. As long as operating profits can scarcely pay the debt (since as explained refinance is not possible/worth it), extending credit facilities is a reckless move, that only causes a slower shareholder-value dissolution in order to maintain the dividend. With a simpler view, the moment GEO fails to meet a single installment, it is not allowed to distribute a single cent to shareholders. To me, that's enough to not categories its dividend as "safe," no matter what. Conclusion: The GEO Group is a stock to stay away from, for numerous reasons. The sentiment towards private prisons is only worsening with socio-political risks being out of the company’s control. Despite that, the company is in massive financial distress. Debt has not only been continuously increasing, but being a private reason REIT and in need of cash, GEO has been forced to borrow at ridiculously restrictive covenants. The company cannot go further under debt and to refinance would be under more strict terms, for the reasons mentioned earlier. The dividend must eventually be cut as creditors come knocking on GEO's door since operating cash flow cannot cover interest payments in the long run. Additionally, in an effort to keep shareholders invested, it's tapping into a revolving facility, instead of cutting down the dividend. The negative long-term outlook, along with its critical balance sheet, should be solid red flags. The market seems to be in line with such concerns since the stock has lost around half its value from its 2017 highs. Finally, a dividend cut should come out as a surprise. I implore both authors as well as investors of the stock to reevaluate the dividend's safety. Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.