FSA Advisory Group October 2023

TRIBAL FINANCING

STATE OF THE MARKET

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Tribes continue to ask, "What do you think interest rates are going to do over the next year?" That is the million-dollar question as we enjoyed a low interest rate environment for the past 13 years, coming out of the Great Recession in 2009 and ending in 2022 when interest rates started to spike as the Federal Reserve has tried to get inflation under control. The Fed has recently said to expect interest rates to be "higher for longer" as inflation continues to persist, pushing interest rates for good credits into the 6.50%-7.50% range compared to those same transactions being financed in the 2.00%-3.00% range at the beginning of 2022. For the sake of this example, SOFR ("Secured Overnight Financing Rate") which took over for LIBOR ("London Interbank Offered Rate") after full retirement in 2023, as the interest rate benchmark for most of the transactions being financed in Indian Country will be used as the base rate which was sitting at 0.05% in January 2022 and is currently 5.31% as of October 16, 2023. The average spread for a good credit with lower leverage in this example will be 150 basis points or 1.50%. Unfortunately, the new norm for the SOFR is not expected to get back to less than 1.00% anytime soon, if ever again. Increasing interest rates may be the most recognizable impact within the tribal financing market but there are several other developments that could be equally as important to Indian Country in the years to come.

"HIGHER FOR LONGER"

If you are wondering what "higher for longer" really means, it is the notion that once the central bank believes that inflation is contained and it will end its current rate-hiking cycle, and interest rates will remain higher for a prolonged period of time before the Fed begins the process of decreasing interest rates again. Based on the notes from the most recent Fed meeting "higher for longer" could be for the next 24 to 36 months. This means that Indian Country may not see significant decreases in interest rates until the end of 2026 and it may actually get worse before it gets better as the Fed is forecasting one more rate hike before pushing the pause button on rate increases.

IMPACT TO INDIAN COUNTRY

Expect interest rates in the 6.50% to 7.00% range for financially strong borrowers for the time being until the Fed begins to decrease interest rates. Banks will also be looking for projects to be scaled back or for Tribes to take a phased approach to reduce financing and project risks during the next 24 to 36 months.

GOVERNMENTAL POLICY & REGULATIONS

The Fed is trying to not repeat the mistake it made in 2018 when it began shrinking its balance sheet through quantitative tightening. The Fed began letting bonds mature without replacing them, pulling cash from the financial system. Hopefully 2023 is different than 2019 when the market seized up and financings came to a halt. However, with less money in the system, many banks are managing liquidity and may not be able to lend as much or as freely as they did over the last 3 years. Couple that with stricter capital rules being proposed by US regulators primarily targeting regional banks, which would require them set aside additional capital to guard against risk, and the impact could be more challenging at best for project financing and devastating to the market in a worst-case scenario.

IMPACT TO INDIAN COUNTRY

Banks potentially writing lower loan amounts as they preserve capital, credit spreads increasing within pricing grids, upfront fees increasing and banks potentially becoming "pickier" and financing "safer" transactions over the next 24-36 months.

BOND MARKET VS THE BANK MARKET

As the Fed Funds Rate continues to increase pushing SOFR higher as a correlated benchmark, the yield curve for the bond market has remained less inflated and, in some instances, when looking at tax-exempt financing, rates within the bond market are more competitive than bank rates. This may be the first time in the last 13 years that the bond market is more competitive than bank loans when considering more traditional tribal deals.

IMPACT TO INDIAN COUNTRY

As the bank market potentially becomes more challenging, it may open opportunities for Tribes to explore the bond market to secure financing for more traditional gaming projects or tax-exempt financings.

IS BIGGER BETTER?

As regulators contemplate stricter regulations on regional banks causing them to be more cautious, larger banks may not have that same issue, providing larger banks with a potential advantage to fund larger loans at a lower cost structure than regional banks. This is a new dichotomy as all banks within Indian Country have been able to provide similarly competitive term sheets for projects but as pressures mount on the market and in particular, regional banks, larger banks may be able to provide more competitive rates and terms. Depending on the deal size, larger banks may be able to fund single bank transactions for a project, where it may take several regional banks to partner together to fund the same project.

IMPACT TO INDIAN COUNTRY

Larger banks may be able to offer better pricing for larger projects over the next 12 to 24 months than regional banks.Unfortunately, larger banks tend to want to finance deals for Tribes with enterprise EBITDA of $25mm and above.

THE EVOLUTION OF NON-GAMING

As bigger banks may develop a competitive advantage regarding pricing over the next 12 to 24 months, one thing that bigger banks have not been able to do as well as regional banks is financing non-gaming projects in Indian Country. As Tribes emerge from COVID, they have focused on further developing their communities, infrastructure, and services they provide their members.FSA is seeing as many non-gaming projects as gaming projects and the evolution of non-gaming is just taking off. As Tribes look to build new administration buildings, health clinics, community centers, judicial buildings, community housing and diversify into businesses outside of gaming, the need for financing non-gaming projects is drastically increasing. Banks that have positioned themselves to specifically serve Indian Country through tribal financial services teams have a competitive advantage if they can effectively finance gaming and non-gaming projects regardless of loan size.

IMPACT TO INDIAN COUNTRY

Regional banks are getting increasingly more comfortable financing non-gaming projects for Tribes and FSA is encouraging more banks (large and regional) to form tribal financial services teams to better serve Tribes wholistically and develop internal structures enabling loan approvals to be made by tribal financial services teams within their respective banks.

RELATIONSHIPS MATTER

As the financing market potentially tightens over the next 12 to 24 months, it will be important for Tribes to have relationships with their banking partners and for banks to develop deeper relationships with tribal clients. Our tribal clients want relationships with the financial institutions they work with and not just to be treated as another transaction. Conversely, financial institutions want deeper relationships with their tribal clients.These deeper relationships will pay off as Tribes begin to execute their 3-to-5-year strategic plans and continue seek financing for gaming expansions and non-gaming projects alike.

IMPACT TO INDIAN COUNTRY

Developing stronger relationships with banks and institutions that understand your Tribe is important. As the supply of money potentially tightens, banks will begin to be more selective with lending and will target lending to better tribal relationships.

THE GOOD, THE BAD & THE UGLY OF GOVERNMENTAL FUNDING PROGRAMS

There are several governmental programs that have been utilized in Indian Country for years like the BIA Loan Guarantee Program or the USDA Rural Initiative. Tribes may want to consider other financing sources such as Essential Governmental Function Bonds to fund governmental projects and infrastructure at low interest rates with longer amortizations or Low-Income Housing Tax Credits which generally provides 70%-90% equity investment that does not have to be paid back by the Tribe.This year Indian Country received $150 million in New Market Tax Credit allocation through CDEs that target Indian Country as their geographic location. These NMTCs can provide up to 30% equity investment into a project that does not have to be paid back by the Tribe. There is also the Tribal Energy Finance Program that has been appropriated $20 billion to deploy in Indian Country to fund a broad range of energy projects.

IMPACT TO INDIAN COUNTRY

Depending on the project, these funding programs can be extremely beneficial to Tribes and should absolutely be considered.However, when using one of these programs, it will be extremely important to have your pre-planning and due diligence items mapped out when going after these funding sources as they can require more documentation and compliance than traditional bank financing. The programs could be more costly than beneficial in the long run.

THANK YOU

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