Lark Research, Inc.

INCOME BUILDER

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HIGHLIGHTS:

- Friday's sell-off will likely usher in a new period of volatility. Gyrations such as those that we have seen over the past three days (9/9, 9/12 and 9/13) often signal a more substantial move (and frequently to the downside). Although the portfolio is well positioned to handle such a move, I will still be paying close attention to market developments over the next few weeks. (p.1)
- Private prison REIT shares were decimated in August when the Dept of Justice directed the Bureau of Prisons to cut all possible ties with private prison operators. (p.2,3,4)
- Corrections Corp. of America (CXW): Although it faces a meaningful loss of revenues and profits from contract cancellations over the next few months, it has adequate financial flexibility and will continue to pursue new contracts with the states and other federal agencies. The stock's 14.1% dividend yield looks attractive, despite the risk of dividend cut. Bonds look attractive too. (p.2.4)
- The GEO Group (GEO) has less contract cancellation exposure and projects in the pipeline that can compensate for the losses. However, it has less financial flexibility than CXW to weather downside surprises. GEO's 11.9% yield is attractive. (p.3)
- ACTION THIS ISSUE: Adding modest positions in CXW (500 shares) and GEO (400 shares). Also adding 10 of GEO's 4 1/8% Senior Notes due 2020. (p.4)

FRIDAY'S SELL-OFF WILL LIKELY USHER IN NEW BOUT OF VOLATILITY

BY STEPHEN P. PERCOCO

Stocks sold off hard on Friday (9/9). The market plunged in the first hour of trading, fell steadily throughout the day and closed with a rush of selling in the final hour of trading.

All told, the major market averages fell 2.5%. All ten S&P sectors declined on the day, led by utilities (down 3.8%) and telecom (down 3.4%). The best performing sector was financial services (down 1.9%).

The media attributed the selling mostly to comments by Boston Fed President Eric Rosengren, a dove on interest rate policy, who said that the gradual normalization of interest rates may be necessary to prevent an overheating in the economy that could jeopardize the cumulative gains in employment.

Besides the plunge in the stock market, yields on long-term Treasury securities rose. The 10-year yield rose 6 basis points to 1.67%, its highest level since the end of June, and the 30-year yield rose 7 basis points to 2.39%.

Surprisingly, short-term Treasury yields, which would be most affected by a rise in the Fed Funds rate, were little changed.

Taken together, the moves suggest that a hike in short-term rates may not be imminent, but an end to this extended period of exceptional monetary accommodation is now on the horizon.

Although the stock market may have been spooked suddenly by the prospect of rising interest rates, there had been signs beforehand that a more decisive shift in Fed policy may be at hand.

Source: Yahoo! Finance

On the previous Friday (9/2), long-term Treasury yields rose, even though many economists suggested that the weaker-than-expected gain in payroll employment would cause the FOMC to hold rates steady in September.

Perhaps in anticipation of Friday's sell-off, long-term Treasury yields rose on Thursday (9/8) by 7-9 basis points.

Contrary to widely-held beliefs, I believe that many investors would welcome a steady, gradual normalization of interest rates, because it would raise confidence about the longer-term prospects for the economy.

Whatever the reason for Friday's sell-off, it should not be ignored. Prior to the plunge, the S&P 500 had not recorded a daily move of 1% or more for 48 consecutive trading sessions (going back to the sharp recovery from Brexit-related losses on June 30).

Although it is very difficult to say whether stocks will trade up, down or sideways in the next few weeks, Friday's sell-off will likely usher in another period of heightened volatility.

Given the advanced age of the current bull market, heightened geopolitical risks and the fragile nature of the global economic recovery, I think that a more significant setback for stocks (and the rest of the global financial markets) is inevitable. But predicting the timing of the switch from bull to bear is always difficult.

The latest round of data support the possible sustainability of the economic recovery. Besides the solid gains in employment and increases in personal income, industrial production has rebounded over the past two months, after a steady string of declines. However, the recent drop in the PMI's below 50 raises the fear that rebound in industrial production may only be temporary, driven perhaps by the fall in the dollar earlier in the year. If so, GDP may struggle to reach consensus expectations for growth of 2%-3% for the balance of the year.

Corrections Corporation of America (CXW)

Change in DOJ Policy Sends Shares Reeling

Founded in 1983, Corrections Corporation of America is the nation's largest owner of private correction and detention facilities and one of the largest operators of private prisons in the U.S. The company became a REIT in 2013. As of June 30, 2016, CXW owned or controlled 49 correction/detention facilities, 25 residential reentry facilities and managed 11 correction/detention facilities. All together, these facilities had 89,300 beds located in 20 states and the District of Columbia.

On August 16, the Dept. of Justice (DOJ) issued a directive to the Bureau of Prisons (BOP), one of CXW's federal customers, to reduce its reliance on privately-owned prisons. That change in policy followed a report issued by the DOJ's Office of Inspector General, which noted some problems at private prisons and recommended a deeper investigation into their causes. A more detailed analysis of this important development is available at www.larkresearch.com/2016/08/21/prison-reit-shares-fall/.

News of the Justice Dept.'s policy change caused CXW's share price to plummet. CXW fell 52% to a low of $13.04 on Aug. 18 before rallying back to close at $17.57, down 35.5% on the day. It has drifted lower to the current level of $15.53 over the past three weeks and is still looking for a bottom.

CXW (and all private prison operators) offer very flexible contract terms to their government customers (both federal and state). Contracts are often structured with initial terms of about 5 years and multiple 1-3 year renewal options. Government customers can also seek to renegotiate key contract terms as circumstances change.

Although construction costs for prisons are not especially high, those relatively short contracts and flexible terms expose private operators to downside investment risk if renewal options are declined or customers seek material contract changes soon after the facilities are placed in service. Facilities can become idled, but having idle capacity can also work in the prison operator's favor when a customer has a sudden need for more capacity.

Still, short contract terms require the private operators to have the financial and organization flexibility to handle an unexpected or sooner-than-expected idling of facilities. At the end of June, CXW had six idle facilities with 6,810 beds (equal to 13.6% of its total capacity) and an aggregate carrying value of $123.7 million. Three facilities had been idled since 2010; the others from 2012-2015. The company has taken average impairment charges of $12.5 million annually on idle facilities from 2013-2015. It risks incurring more impairment charges if it cannot obtain new contracts on its currently idled facilities.

CXW has mitigated the risk in its core business by maintaining a solid capital position and diversifying its business mix. It debt-to-capital ratio is about 50% and its debt is rated one or two notches below investment grade at Ba1/BB/BB+. CXW has also expanded into community corrections facilities (i.e. halfway houses) and now offers real estate leases on its facilities (which allow customers to operate the facilities themselves).

The Aug. 18 announcement by the DOJ makes it highly likely that CXW's roster of idle facilities will grow in the next 6-12 months. The company has already announced that the BOP has declined to renew its contract for the 1,129-bed, Cibola County Corrections Center in Milan, NM (which expires in Sept.).

Its contract on the 1,978-bed, McRae Correctional Facility in McRae, GA is up for renewal in November. It is a pretty easy bet that the McRae contract will not be renewed.

CXW's contract on the 1,422-bed, Eden Detention Center in Eden TX is up for renewal in April 2017. Under the recent amendment to the Criminal Alien Requirement XVI (CARS 16) solicitation, the BOP will reduce its contracted prison beds from 10,800 to 3,600 located in two yet-to-be-named facilities in Texas. The Eden Detention Center appears to be a good candidate for one of those slots; but competition for the award will almost certainly be stiff.

CXW Valuation Metrics

Recent price	$ 15.36	
52-week range	$ 13.04	- $ 35.05
Dividend	$ 2.16	
Yield	14.1%	
Dividend payout	125.3%	
Shares outstanding	118	million
Market cap.	1,805	million
	EPS	**PE**
ttm (GAAP)	1.72	8.9
ttm (FFO)	2.52	6.1
2016E	2.66	5.8
2017E	2.06	7.5
	Per Share	**Multiple**
Free cash flow	$ 2.72	5.6
Book value	$ 12.29	1.2
Tangible book	$ 11.97	1.3
Sales (ttm)	$ 15.47	1.0

CXW's contract on the 2,232-bed Adams County (MS) Correctional Center is up for renewal in July 2017. Under the current DOJ directive, it is also a pretty fair bet that CXW will also lose this contract. However, the incoming presidential administration, especially if it is a Republican administration, may reverse the recent changes in DOJ and FOP policy toward private prisons. In that case, CXW might keep its contracts on both the Eden Detention Center (even if Eden does not win under the new CARS 16) and the Adams County Correctional Center.

CXW has also announced that it has been approached by Immigration and Customs Enforcement (ICE) to renegotiate the terms of its contract with the South Texas Family Residential Center (STFRC). This facility serves families (mostly women and children) that are caught crossing the border. In 2015, under pressure from immigrants' rights groups, ICE began to limit the amount of time that these families stay in detention. (Lawsuits asserted that families should not be kept in detention since most were seeking asylum.) The change has caused a decline in utilization of the South Texas facility and ICE wants to explore ways to lower its costs. Along with this request, ICE has solicited proposals for the development of one or more new family residential centers.

It is clear, therefore, that earnings from the STFRC will come down, but it is difficult to estimate where they are now and where they might go. SEC filings indicate that revenues for the STFRC were $284.5 for the rolling 12 months ended June 30, 2016. CXW has also said that profit margins for the STFRC are higher then the company average. Company EBITDA margins are 24.4% currently and I am guessing that the STFRC's margins are around 30%. Under these assumptions, the STRFC, which accounts for 3.4% of CXW's beds, generates about 15.6% of its revenues and an estimated 19.3% of its EBITDA.

I am going to guess that the negotiations with ICE will cut STFRC's profitability in half. In that case, about 9.6% of CXW's EBITDA or roughly $43 million is at risk at STRFC alone. On the positive side, CXW stands to gain if ICE chooses it to develop any new family residential facilities, but it will take time to build and activate any new project.

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The GEO Group (GEO)

Change in DOJ Policy Sends Shares Reeling

On August 18, the day after the Justice Dept. released its memo directing the Bureau of Prisons (BOP) to reduce its ties with private prison operators, GEO shares plummeted nearly 50% at the open and closed the day down 40%. Since then, they have meandered, but at yesterday's close (9/13), they are up 11.8% from their Aug. 18 close, but still down 32.4% from the day before the DOJ announcement.

GEO obviously faces many of the same challenges as CXW, but there are some notable differences. First, GEO does much more business with the BOP (as a percent of its total business) than CXW. The federal government accounts for about 45% of GEO's revenues, which is lower than CXW's 52.5%, but the BOP accounts for 18.1% of its total capacity, compared to 9.9% for CXW.

The contract on GEO's 1,878 bed Moshannon Valley Correctional Center was renewed in February 2016; but the 2,847-bed D. Ray James Correctional Facility is up currently up for renewal in September. On August 19, the company issued a press release saying that its contract for D. Ray James had been renewed, but then quickly withdrew it that same day. Odds are, I believe, that because of the change in DOJ policy, D. Ray James will lose its contract.

After that, the contracts for three correction facilities located in Texas (with 7,272 beds) come up for renewal in the 2017 first quarter. There is a good chance that one of these facilities will be picked up by BOP under the revised CARS 16 solicitation; but the fate of the others may fall to the incoming presidential administration.

Three other notable difference of GEO (vs. CXW): First, GEO has several facilities outside the U.S., including four in Australia, one in the U.K. and one in South Africa.

The company is currently developing the 1,300-bed, Ravenhall Prison Project near Melbourne, Australia in a public-private partnership with the state of Victoria. The prison will provide extra capacity to the state, but is also being designed to emphasize programs intended to reduce recidivism. GEO has already incurred $300 million of costs and will likely spend another $100 million or more, before the project is completed in late 2017. GEO will be reimbursed for the development costs, but will contribute $88 million as a permanent equity for the project. It expects to receive $75 million in annual revenues for managing the facility, which should give GEO a meaningful boost to its profitability and an attractive return on its investment. The company has also disclosed recently that it is bidding on a similar project in New South Wales, Australia.

The second difference (between GEO and CXW) is GEO's greater emphasis on community reentry programs and youth services through its GEO Care segment. To be sure, CXW has a significant presence in this segment too, but GEO seems to have placed greater emphasis in this area and integrated its programs more tightly with its core U.S. correction facilities.

Third, GEO is more highly leveraged. Its total debt has increased over the past couple because of the construction costs associated with Ravenhall. At June 30, its ratio of debt-to-total capitalization was 70% vs. 50% for CXW. I calculate rolling 12-month EBITDA coverage of interest expense at 3.2 times for GEO, compared with 7.1 times for CXW. Debt-to-EBITDA is 5.8 times for GEO, compared with 3.3 times for CXW.

These differences are also reflected in the two companies' debt ratings. GEO's debt is rated B1/B+ at the mid-tiers of the junk bond market; while CXW is rated just about a notch below investment grade at Ba1/BB/BB+. Yields on comparable maturity GEO bonds are 500-700 basis points higher than CXW.

GEO's will receive $300 million or more in cash sometime in 2017, once the Ravenhall project is completed and approved by the state of Victoria, but new projects may limit the pay down of GEO's debt. For that reason, GEO should consider issuing some equity, if and when investor attitudes toward the private prison REIT sector become positive again.

GEO Valuation Metrics

Recent price	$ 21.82	
52-week range	$ 16.26	- $ 35.14
Dividend	$ 2.60	
Yield	11.9%	
Dividend payout	139.8%	
Shares outstanding	74	millions
Market cap.	1,616	millions
	EPS	PE
ttm (GAAP)	1.86	11.7
ttm (FFO)	2.67	8.2
2016E (FFO)	2.89	7.6
2017E (FFO)	2.86	7.6
	Per Share	Multiple
Free cash flow	$ 1.06	20.5
Book value	$ 13.06	1.7
Tangible book	$ 1.86	11.7
Sales (ttm)	$ 27.39	0.8

Despite CXW's stronger financial position, GEO's stock trades at a meaningfully lower yield (11.9% vs. 14.1% for GEO) and its P/E and P/FFO multiples are modestly higher. GEO pays out a higher proportion of its earnings (and FFO) as dividends, but stock investors have been willing to pay up at this time, probably because they see less downside risk to GEO's future earnings. Indeed, consensus estimates anticipate that GEO's earnings will be relatively flat from 2016 to 2017; whereas CXW's earnings are expected to fall 25%-30% in 2017.

The consensus view seems to be that GEO will fare better in the current environment, but the company still faces contract renewal risks at some of its BOP facilities, as well as the risk, however small, of problems arising around the completion and activation of Ravenhall. (It is surprising that GEO's contract with the state of Victoria did not provide for progress payments during construction.)

GEO's low valuation and high dividend yield therefore reflects concerns that it still runs the risk of a more significant decline in profitability should, for example, its 2017 BOP contracts fail to be renewed or other federal and state agencies begin to reduce their reliance on private prisons. In that case, the 2017 consensus FFO estimate of $2.86, which is roughly on par with 2016, would prove to be too high, and GEO would be forced to cut its dividend.

In the near-term, however, those risks seem overplayed. Management has affirmed its adjusted 2016 FFO guidance of $3.60 (which translates into FFO near the $2.90 consensus). Even if GEO were to lose 70% of its BOP contract beds, I estimate that its FFO would drop by about $0.70 cents and its dividend by about $1.00 (to give it an extra cushion). This would reduce GEO's dividend yield to 7.3% at the current price (but the stock would probably still fall more anyway, until GEO proved itself capable of sustaining the lower dividend rate).

Accordingly, I am taking a modest position of 400 shares in GEO at this time. I am going to pass on the bonds for now, even though they may have more upside potential than CXW's bonds (in 2017, with the successful completion of Ravenhall).

(Continued from page 2)
Applying a similar methodology to the at-risk BOP facilities, I estimate that CXW will probably lose $90 million in revenues and $21 million in EBITDA from the closing of the Cibolla County Corrections Center in September and from the expected closing of the McRae Correctional Facility in November. It might also lose another $106 million in revenues and $25 million in EBITDA from the possible closure of the Eden Detention Center in April 2017 and the Adams County Correction Facility in July 2017.

Focusing on the most likely losses (i.e. Cibolla, McRae and 1/2 of the STFRC), I believe that CXW stands to lose $233 million in revenues and $90 million in EBITDA. (In this case, the decline in profitability also reduces adjusted FFO and net income by a similar amount.) This estimate does not reflect either the potential gains from one or more new contracts for residential family centers from ICE or other efforts to utilize idle facilities, make acquisitions or cut costs.

Assuming no offset to these estimated losses, I calculate that CXW's earnings will fall from $1.72 (on a rolling 12 month basis) to $0.96 and adjusted funds from operations (FFO) per share from $2.65 to $1.71. Consensus estimates currently anticipate EPS of $1.84 in 2016 and $1.30 in 2017 and adjusted FFO of $2.66 in 2016 and $2.06 in 2017. The estimated benefit from new business development activities, including the leasing of the previously idle North Fork Correctional Facility (2,400 beds), the full year benefit from the new Trousdale Turner Correctional Center (2,522 beds) and growth in the residential reentry business are presumably already reflected in consensus estimates, but not in my "loss only" estimates.

According to company policy, dividends are set at 80% of adjusted FFO per share. According to my estimates, the dividend could fall from $2.16 to $1.52, unless the company finds a way to make up for the profit losses from these facilities. In the long-run, CXW should be able to more than make up for this potential loss, but in the short-run, it may be hard-pressed to cover all of the shortfall.

At the current price of $15.36, CXW shares are trading at 8.3 times the 2016 EPS consensus estimate of $1.84 and 11.8 times the 2017 EPS estimate. They are likewise trading at 5.8 times the 2016 Adjusted FFO consensus of $2.66 and 7.5 times the 2017 estimate of $2.06.

If the dividend is cut from $2.16 to $1.52, as my "loss only" scenario anticipates, the yield on CXW stock at the current price would fall from 14.1% to just under 10%. Clearly the stock is cheap and the market is implicitly anticipating a much more severe dividend cut than I have envisioned here. In my greater downside scenario, where CXW also loses Eden and Adams County in 2017, the dividend would drop to $1.38, equal to a 9% dividend yield at the current price. A reasonable case can be made, therefore, that the stock already discounts more than a severe drop in CXW's profitability. It suggests that the market is concerned that the profit decline will be much worse than what I have estimated here in my "loss only" scenario, which is already well below consensus estimates.

It is possible that the market is anticipating a decline in earnings from the STFRC that is even worse than the 50% drop that I have assumed. More likely, it may be worried that the decline in use of private prisons by government customers will extend to ICE, the U.S. Marshall's service and even some state prisons. Both CXW and one of its primary competitors, the GEO Group (also reviewed in this Bulletin) make the case that their business with these institutions is unlikely to decline (mainly because the specific needs of their prisoner populations will not change). In fact, yesterday's Wall St. Journal (9/13) reported that the number of inmates at many states is climbing back up, despite bipartisan efforts to reduce prison populations. To me, the real worst case scenario might occur in a severe recession when both the federal and state governments face severe budget crises and call upon the private prison operators to cut their rates drastically (but probably temporarily) to help them close any budget gaps.

Even though the CXW's stock is cheap, it could still conceivably fall more, because consensus estimates are probably too high and the loss of additional BOP contracts or a more severe profit cut at STFRC could disappoint investors. For that reason, I have decided to take a partial position in CXW of 500 shares and will probably look to add more, if the stock declines further.

I also view CXW bonds as attractive. At the current time, I favor the shorter maturity, 4 1/8% Senior Notes due 2020 which traded most recently at 96.50 to yield 4.9%. That represents a spread of about 380 basis points over the comparable maturity Treasury note. CXW's longer maturity bonds have even higher yields and more upside, but they will also likely be more vulnerable to gyrations in the high yield market. I am adding 10 of the 4 1/8% Senior Notes to the fixed income portfolio.

Portfolio Changes

Bulletin 1446, September 14, 2016

COMMON STOCKS Company	Ticker	Action	Existing Shares	Change in Shares	Recent Price (9/13/16)	Safety Rating	Performance Rating
Corrections Corp. of America	CXW	Buy	0	500	15.36	D	1
The GEO Group	GEO	Buy	0	400	21.82	D	1

BONDS Issuer	Type	CUSIP	Action	No. of Bonds	Recent Price	Coupon	Yield	Maturity	Call Date/ Price	Ratings
Corrections Corp.	Senior Notes	22025YAM2	Buy	10	96.50	4.125%	4.90%	01-Apr-20	01-Jan-20 100.0	Ba1/BB/BB+

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