

Credit FAQ:

Could A Slowdown Shackle The U.S. Prison Industry?

October 12, 2023

This report does not constitute a rating action.

Weak macroeconomic conditions and slowing consumer spending could challenge incarceration rates, consumer spending, and state budgets, affecting the overall U.S. prison industry. In particular, private prison operators, communication service providers, and commissary companies may experience different degrees of disruption. In addition to macroeconomic pressure, these companies also face legislation reform, ongoing litigation, and heightened investor sensitivity to ESG concerns. In this piece, S&P Global Ratings answers frequently asked questions about how a challenging economy and legislative actions could influence the credit quality of entities with ties to the U.S. prison industry (see company list in appendix).

Frequently Asked Questions

How can a weak economy affect incarceration rates?

We do not believe U.S. GDP growth has a strong causal effect on incarceration rates. More important is the longer-term trend of slowly declining rates of incarceration. Since around 2010, prison populations have been trending down by low-single digit percentages annually, regardless of economic conditions. However, in 2020, the COVID-19 pandemic led to a significant decline in the population of incarcerated individuals, with the population falling around 13% compared to 2019. Many things drove this decline, including early releases to reduce population density and alleviate health concerns, fewer arrests, slower court processing, and some prisons refusing to accept transfers from local jails. The population of incarcerated individuals saw a slight uptick in 2021 and 2022, especially in local jails where rates are now approaching pre-pandemic levels. However, the overall population of inmates in federal and state prison facilities remain 10%-15% below pre-pandemic levels.

For most companies with exposure to this industry, higher populations are typically better for business. Phone operators have more people use their services and commissary companies sell more products. Private facility operators, however, face a somewhat mixed effect from population change. U.S. Immigration and Customs Enforcement (ICE) facilities, which make up about a third of private prison revenues, are generally flat-rate contracts. ICE generally pays for a set number of beds regardless of use. Prior to the pandemic, utilization rates were 80%-85%, but pandemic caps limited occupancy around 70%. As the government lifts pandemic-era capacity restrictions, occupancy rates are likely to return closer to pre-pandemic levels. Private prison operators like The GEO Group Inc. (B/Stable/--) and CoreCivic Inc. (BB-/Stable/--) have begun to invest in additional staff to handle increasing occupancy, and while the additional servicing costs currently weigh on margins, profitability may increase if occupancy rates normalize in 2024 and 2025.

How does tightening consumer spending challenge prison phone operators and commissary companies?

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Could A Slowdown Shackle The U.S. Prison Industry?

The nature of the phone operators' business is more discretionary compared to food providers. The client base for these companies comprises primarily low-income families and individuals that feel pressure from inflation and lower discretionary income the most. As the cost of necessities increase for these families, discretionary spending tightens, resulting in lower funding to inmate accounts. We saw evidence of this in 2022, with revenues down roughly 7% and the impairment exacerbated by the absence of government stimulus that propped up demand in 2021. For phone operators, a recession could lead to lower spending on traditional calls and on a la carte media items, like movies and music, through the companies' tablet businesses. However, we don't expect the decline to be as severe as 2022's level, given our believe that increasing tablet rollouts will partly offset lower tablet revenue per device.

While commissary companies may feel some of this pressure as well, these items are typically less discretionary. We also expect tighter account balances will lead to inmates choosing private-label products over name brand. Private label products tend to have a better margin profile for the company, which will help offset some bottom-line revenue loss.

How do state budgets affect the industry?

Of our rated companies with ties to the U.S. prison industry, private prison operators have the greatest exposure to state budget decisions, given about 30% of their revenues come from state governments. In a challenging macroeconomic environment, we expect state budgets will be tight, so states may seek to contract out more inmates to private prison operators and outsource to commissary companies that offer more cost-effective services compared to government-owned prisons. We believe private prison operators can deliver services at prices about 10%-15% below those of public operators. State correctional budgets are also beginning to play a larger role for phone operators as some states are moving to a taxpayer-funded model where the facility pays for communication services rather than inmates. While this increases phone operators' exposure to budget decisions, it helps insulate them from the volatility of tighter discretionary spending for low-income individuals and families.

The governments of both blue- and red-leaning states have stated that corrections account for too large of a portion of state budgets, and we expect longer-term funding to face pressure. Blue states may aim to reduce inmate populations while red states focus more on the cost of services, which could result in lower rates for phone providers when contracts come up for renewal.

What legislation is key to the credit quality of companies within the U.S. prison industry?

Title 42 was created to protect public health and social welfare and had been in place for years before it was largely exercised beginning in March 2020 at the onset of the COVID-19 pandemic. The code enabled the government to send immigrants who had entered illegally while seeking asylum back across the border. President Biden moved to end Title 42 in early 2022 but faced pushback from border states that did not feel equipped to handle a surge of migrants; as such, the regulation remained in place until May 11, 2023.

Private prison operators proactively ramped up staffing and capacity in anticipation of increased demand, so we expect higher utilization rates for contracted ICE beds will drive margin expansion in 2024 and 2025. New regulations replacing Title 42 may limit the increase in ICE populations to some extent, such as the Circumvention of Lawful Pathways rule. This rule will deem migrants who travel through a third country before reaching the U.S.-Mexico border as ineligible for asylum. That said, we still expect ICE volumes will increase from pandemic-era lows. In the longer term, we expect this to support ICE contract renewal volumes due to the increased demand for beds.

State-level bail reform is another form of legislation that could affect private operators. Many states are considering no-cash bail, which has mixed implications for private operators. While we believe private prison population will fall due to bail reform, we also expect the companies to benefit from higher use of in-home ankle monitoring services. Ankle monitoring will likely be accretive to the companies' margin profiles due to lower costs compared to in-facility detention. In particular, we believe this shift can benefit GEO, which holds the federal electronic monitoring

Could A Slowdown Shackle The U.S. Prison Industry?

contract through July 2025. Phone service provider Aventiv Technologies LLC (CCC+/Watch Neg/-) also provides in-home and mobile ankle monitoring solutions to partially offset a decline in population due to bail reform.

Congress approved the Martha Wright-Reed Just and Reasonable Communications Act in December 2022, which expands the Federal Communications Commission's (FCC's) authority to regulate intrastate and video communications, in addition to interstate calls that were already under its purview. Most phone calls were already under FCC jurisdiction due to the proliferation of mobile phones, since location cannot be accurately determined by using the area code associated with the incoming phone number, resulting in most calls deemed as interstate. Additionally, call rates for both companies are already below existing FCC caps.

However, rate caps could decline in the future given that the law requires just and reasonable rates for prisoners. It also eliminated the requirement that phone operators receive fair compensation on all calls. The act implements rates that are calculated by considering the costs of safety and security measures necessary to provide inmate service, using industry averages to ensure fair compensation. The companies have both provided cost-related data to assist the FCC in setting rates for video communication, and we do not expect these caps will have a material impact on the business as video calls are already low in profitability and make up only a small portion of each companies' total revenue.

What litigation concerns could create headwinds?

GEO and CoreCivic are both embroiled in labor lawsuits connected to voluntary worker programs in which inmates are paid well below minimum wage. The dispute is centered on whether immigrant detainees are considered employees of GEO and should be paid state-level minimum wage instead of the \$1 per day requirement set by federal regulation. The outcome of labor-related litigation has varied by state. Lawsuits filed against CoreCivic in Maryland and Texas were dismissed in recent years. Another lawsuit in Georgia is ongoing, and a lawsuit in California could rise to the Supreme Court for review. GEO faces similar litigation in Colorado, Washington, and California.

Global Tel*Link Corp. (doing business as Viapath; B/Stable/--) also settled a class-action lawsuit after seizing funds from inmate accounts that had been declared inactive. The settlement resulted in the company paying \$2 million in 2022 and will pay an additional \$2 million in 2023. From April 2011 to August 2019, the company seized over \$121 million in funds from accounts deemed to be inactive.

Each company tied to the U.S. prison industry has significant exposure to litigation, and we believe this represents a material credit risk.

How does shifting to a free-call model affect prison phone operators?

We view this as a risk to profitability over time. Several local governments have begun to implement a model whereby facilities, rather than inmates, pay the phone operators for their services. We believe profits could shrink as operators are forced to negotiate with entities with more negotiating leverage. Furthermore, facilities often receive commission payments from operators providing phone calls. In the past, facilities and the phone operators were both incentivized to keep call rates high, maximizing profit for the phone operators and commission payments for the facilities. Under the free-call model, this partnership dissolves. However, we recognize that this model is still nascent. Wide-spread adoption may face political resistance as the burden to fund inmate calls would shift to taxpayers from inmates' families. Therefore, this move may not be popular, especially in more conservative-leaning locations.

How are ESG concerns changing investor sentiment?

Regarding debt refinancing and access to capital markets, we believe near-term concerns are concentrated with the prison phone operators. Several investors have already removed themselves from investing in the industry due to ESG concerns. We expect advocacy groups will continue working to persuade investors against putting money into the space. While the risk of

Could A Slowdown Shackle The U.S. Prison Industry?

additional investors exiting the space remains, the base is already materially smaller than it was in the past. Given the limited size of the current investor pool, it could be increasingly difficult and costly for companies to secure financing. For example, CoreCivic's 2021 notes offering was oversubscribed, but at a substantially higher cost of capital than historical debt issuance. While this is especially true for the companies operating with higher leverage and more strained cash flow metrics, we note that both GEO and CoreCivic have seen a material decline in revolving credit commitments from banks in recent years. Maturity walls for private prison operators and TKC Holdings Inc. (B-/Negative/--) are fairly minimal, with no significant debt maturities until 2026.

Credit metrics for prison phone operators Viapath and Aventiv had been trending in opposite directions. The companies have both invested heavily in tablet technology over the last few years, but Viapath has been more efficient in rolling out the new technology. Viapath issued a \$215 million add-on to its second-lien term loan in early 2022 to fund a dividend to its private equity sponsor, American Securities. Since the transaction, the company has successfully reduced leverage through cost reductions that drove EBITDA growth.

In May 2023, Aventiv proposed a refinancing transaction that would address tightening liquidity and near-term debt maturities. The transaction as initially proposed would have included an infusion of \$400 million in equity contributed from financial sponsor Platinum Equity. The deal would have also included the issuance of a \$700 million term loan and \$400 million of senior secured notes. However, the deal failed to gain traction and there was limited interest in the company's proposed notes offering. At this stage, we believe it is unlikely for the transaction to close under the initial terms. If Aventiv cannot complete a transaction that improves its liquidity position, we believe the company will need to receive a capital infusion or substantially reduce its capital expenditure to avoid a liquidity shortfall.

Appendix

Rated entities with ties to the U.S. prison industry

Private prison operators

CoreCivic Inc. (BB-/Stable/--)	CoreCivic is a leading provider of criminal detention and residential re-entry facilities in the U.S. The company operates through three segments: Safety (about 91% of revenue for the nine months ended Sept. 30, 2022, and 85% of net operating income [NOI]) includes correctional facilities with programming, recreational, courts, and administrative spaces; properties (about 3% of revenue and 11% of NOI) leases real estate to government tenants; and community (about 6% of revenue and 4% of NOI) provides correctional services for residential re-entry facilities and nonresidential services to states and localities.
The GEO Group Inc. (B/Stable/--)	GEO is a leading provider of criminal detention and residential reentry facilities in the U.S. It conducts its business through four reportable business segments: U.S. secure services (61% of year-to-date revenue) primarily encompasses its U.S.-based support services for correctional facilities, detention facilities, and immigration processing centers; electronic monitoring and supervision services (20%) provides U.S.-based monitoring services and evidence-based supervision and treatment programs for community-based parolees, probationers, and pretrial defendants; reentry services (11%) provides residential and nonresidential treatment, educational and community-based programs, and pre-release and halfway house programs; and international services (8%) primarily comprises detention centers in Australia and South Africa.

Communication services

Aventiv Technologies LLC (CCC+/Watch Neg/--)	Aventiv is a telecommunications and technology platform company that primarily provides services to correctional facilities in the U.S. Voice and video calls, which are regulated by the Federal Communications Commission, generate 50% of revenue. An additional 26% of revenue is generated through media and e-messaging services, with the remainder coming from payment processing and monitoring services. The company often makes commission payments to correctional institutions or government agencies for which it provides communication services. As a result, Aventiv is trying to diversify its revenue with ancillary services not subject to the same regulatory oversight and commission payments as voice and video calls.
Global Tel*Link Corp. (B/Stable/--)	Global Tel*Link, doing business as Viapath, primarily provides inmate telecom services to correctional facilities in the U.S. Most of its revenue comes from traditional voice calls that the FCC regulates. These services also often require the company to make commission payments to correctional institutions or government agencies. As a result, the company diversified its revenue with ancillary services that are not subject to the same level of regulatory oversight and commission payments as traditional voice services. These include payment services, video visitation, and tablets (for educational and media content), which the company added or enhanced through various acquisitions over the past

Rated entities with ties to the U.S. prison industry

Private prison operators	
	several years. The company primarily faces competition from Aventiv, which has comparable market share. The two companies represent about 90% of the inmate telecom market.
Commissary Services	
TKC Holdings Inc. (B-/Negative/--)	TKC provides commissary, food service, and technology products and services to the corrections industry. TKC operates as a portfolio company with three segments: Commissary services (about 62% of revenue) provides fully outsourced service and technology for correctional commissaries, including wholesale distribution (handling inmate account setup, funds transfer, sales and purchases of food, personal care products, clothing, and other items); food services (22%) provides outsourced food services to correctional facilities; and ancillary services (16% provides software, telecommunications services, customized package programs, and entertainment to correctional facilities and distributes coffee and operating supplies to hotels.

Related Research

- Aventiv Technologies LLC Ratings Placed On CreditWatch Negative On Delayed Closing Of Transaction, Sept. 18, 2023
- Tear Sheet: TKC Holdings Inc.'s Second-Quarter Earnings Highlight Progress Against Inflation, Sept. 18, 2023
- The GEO Group Inc., Aug. 15, 2023
- Global Tel*Link Corp., April 7, 2023
- CoreCivic Inc., Nov. 21, 2022

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