TFA Monthly Newsletter

September 2022

It Was Good While It Lasted…Higher Interest Rates May Stick Around for Awhile

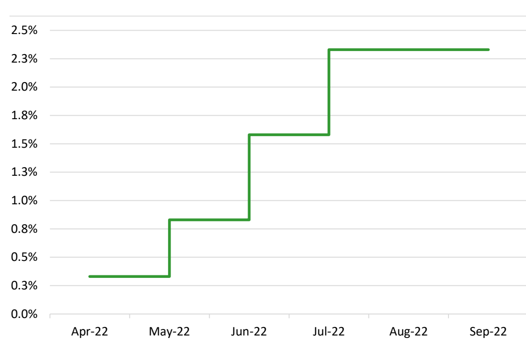
By David Howard

On August 26th, the Federal Reserve Chairman, Jay Powell, gave a speech from Jackson Hole and reiterated the Fed's commitment to battle the economy's stubborn rising inflation aiming to curb it to a more sustainable 2% annual growth level. Investors saw Powell's hawkish comments as aggressive and were hoping he would give some signal that the Fed would pivot away from tightening monetary policy in 2023, but he didn't. The Dow Jones Industrial average immediately fell more the 1,000 points on that Friday and has dropped another 1,000 points since then. Long story short – higher interest rates are expected to be here for a while and business enterprises with significant debt loads are going to see profits and net cash flow diminished as a result.

What is the Fed Funds rate and why does it matter?

The Federal Funds rate is the interest rate that banks charge each other for unsecured overnight loans needed to meet reserve requirements or to lend to their customers. If it costs banks more to borrow, they are going to pass those increased costs along to their borrowers. The Federal Reserve sets a target rate range as a guide for the banks, and buys and sells government bonds in "Open Market Operations" in order to achieve that range. Right now, the range is 2.25% to 2.5%. The chart below shows what the Fed has being doing the past 6 months, including a 0.75% rate hike in both June and July – and more is expected before the end of the year.

Federal Funds Rate - Last 6 Months: (macrotrends.net)



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IN THE NEWS

UK Gambling Revenue Drops in June as Almost All Sectors Struggle
8/4/22 – igamingbusiness.com

Twitch's Gambling Boom Is Luring Gamers Into Crypto Casinos
8/6/22 – Bloomberg.com

Commercial Gaming Sets All-Time Quarterly-Revenue Record at $14.8 Billion
8/11/22 – cdcgamingreports.com

Indian Gaming Revenue Jumps To Record $39 Billion
8/11/22 – nativenewsonline.net

NYC-Area Casino Outlook: Not Particularly Soon, And Not In Manhattan, Experts Tell Conference Attendees
8/16/22 – nyonlinegambling.com

Legal Changes Make Colorado An Enticing Casino Market For Nevada Operators
9/4/22 – thenevadaindependent.com

California's Counties Latest To Oppose Proposition 27
9/5/22 – pechanga.net

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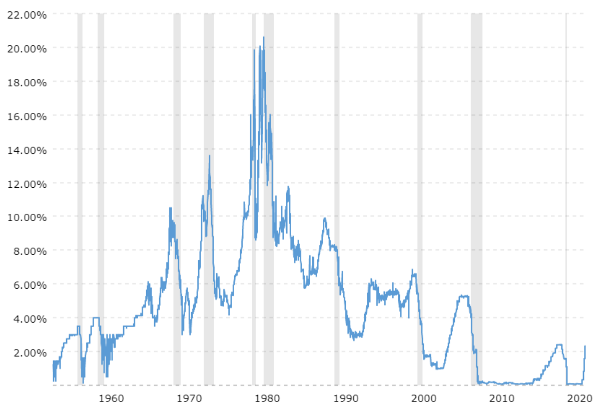
From a historical perspective, this isn't a crazy interest rate environment. We have just been the beneficiary of exceptionally low interest rates for the past decade and it's been great for business.

Federal Funds Rate - 62 Year Historical Chart: ([macrotrends.net]())



A significant portion of tribal debt, especially gaming debt, is based on a floating rate index plus a credit spread. In theory, the floating rate index represents the banks' cost of funds. The credit spread is banks' profit based on the risk they feel they are taking. Previously, the universal floating index was LIBOR (the London Inter-Bank Offered Rate); however, this index has been replaced with SOFR (Secured Overnight Financing Rate) in an effort to better represent the banks' true cost of funds. To the right is the latest forecast of the SOFR index.

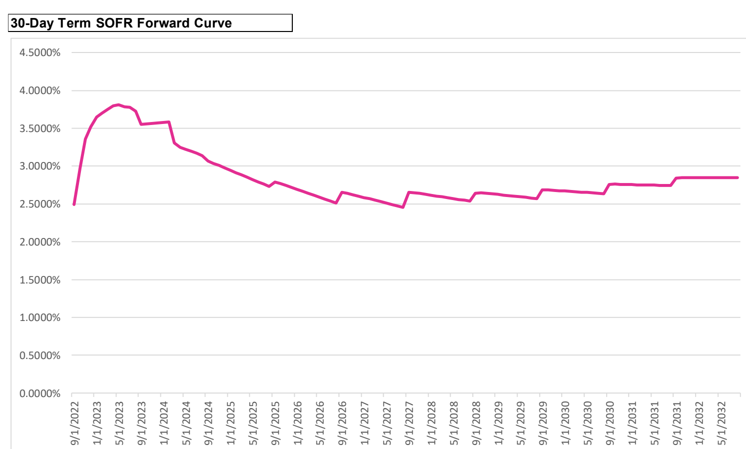
What does this mean for tribal finances?

Interest rates have been increasing and likely won't peak until mid-2023. Assuming a tribe was borrowing at SOFR + 1.50%, over the past year, its interest expense has increased over 170%. That exceeds recent increases in construction costs, gas, wages and just about every other expense line item.

Additionally, in our recent conversations with several bankers, the following trends have emerged: (1) Banks aren't going to be as willing to push the envelope on tough deals given present geo-political strife, persistent inflation, supply-chain issues, etc. While not over-concerned with tribal gaming credits, they want to stay in the middle of the fairway. (2) In addition to the forecasted floating rate increases, credit spreads will also increase - a double whammy to tribal borrowers. For the same reasons mentioned above, banks are perceiving slightly more risk and they feel they need to charge more on the credit spread. Bank's own cost of capital is also increasing, and they are passing that cost along to customers. It won't be significant, but don't be surprised if credit spreads increase 25 to 50 bps over the next year.

Given inflationary pressure on the consumer, growing the top line to offset increased interest costs will be difficult for businesses, especially casino operations. In forecasting tribal budgets, leaders need to be mindful of the impact to distributions from their business enterprises that have significant debt. Additionally, new construction projects will need to provide higher returns if these projects are funded with new debt.

Some good news. Many tribes have taken advantage of the previous low-rate environment and used free cash flow to repay debt. Tribes with strong cash resources or access to low-cost debt, may find more attractive acquisition opportunities and the flexibility to pursue them. As always, we look forward to discussing any of these trends and ideas with you at any time.



Source: Bloomberg Professional

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