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Total Leverage: Balancing Risk

by William Crader, CFA

What is the right level of debt for a Tribe? This is a simple and straightforward question that is often asked in Indian Country, but the answers are varied and nuanced. The short answer: It depends. Before we provide our view, let's review some standard finance jargon.

Total Leverage. In the finance world the concept of "Total Leverage" is used as a primary measure of financial risk associated with debt. The calculation of Total Leverage is Total Debt divided by the last twelve months of EBITDA (or cash flow). For example, if a Tribe has $100 million of debt and its enterprises generated $50 million of EBITDA in the last year, Total Leverage is 2.0x (Total Debt / EBITDA = Total Leverage). One way of looking at this is if the Tribe utilized all its cash flow to repay debt, it would take just over 2 years to be debt free (2 years for the debt, plus a little longer for the interest). Generally speaking, commercial banks will lend to Tribes up to 3.0 - 4.0x existing cash flow. Institutional investors can potentially provide capital north of 4.0x Total Leverage, but the interest rate associated with this type of debt will be materially higher. For the most part, a Tribe with Total Leverage equal to or less than 2.0x is considered to be a high-quality credit with debt that is refinanceable.

Good Debt. Similar to personal finance, "good debt" provides a Tribe the necessary capital to invest with the goal of generating more cash flow or maintain its current level of

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9/4/18 – NHoNews.com

Senate Committee On Indian Affairs Set To Advance Three Bills

9/12/18 – Indianz.com

California Indian Tribe Not Liable in Multi-Million Dollar Dispute

9/18/18 – CalvinAyre.com

Ponca Tribe Cuts $250,000 Check To Carter Lake For New Casino — The First Of Several Payments

9/18/18 – Omaha.com

Department Of Justice Plans Increase In Tribal Safety Funding

9/19/18 – Indianz.com

Westward Ho

9/26/18 – GGBMagazine.com

Governor Signs Bill Allowing Off-Track Wagering At Chumash Casino

9/27/18 – SYVNews.com

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cash flow. This includes debt used to refurbish or expand a Tribe's casino enterprise or acquire a new business. Debt is an essential tool to managing capital reinvestment and can also help a Tribe preserve its precious cash balances, which can provide a Tribe greater financial stability or be used for higher return investment opportunities. Using our earlier example, if that Tribe borrowed an incremental $100 million, which now means the Tribe has total leverage of 4.0x, but expects to increase cash flow by $25 million, that Tribe would clearly be in a better financial position in the long run. This is especially true if the Tribe pays down its debt. It would be reasonable to assume within 5 years that Tribe would enjoy higher levels of cash flow and, with debt repayment, would be well below 2.0x leverage.

What Keeps Us Up at Night. The trouble with financial leverage appears when the demands on cash flow from a Tribe's enterprises become overly burdensome. There is also increasing concern about rising interest rates, which can place more strain on a Tribe's cash flow. A Tribe could be relatively low levered, say 2.0x, but if all of its cash flow is being consumed by Tribal government programs, including per capita payments, and debt repayment is being deferred, then its credit quality is likely to be affected. In essence, spending cash flow versus using it for debt repayment (reducing financial risk) or capital investment (which should increase revenue and cash flow) can lead a Tribe to an uncertain financial position in the long run. Returning to our example again, assume the Tribe's cash flow is reduced by 50% and decreases to $25 million annually. That would leave the tribe at 4.0x total leverage ($100 million / $25 million = 4.0x). Clearly this is a scenario to be avoided.

So, What's the Right Total Leverage? The easy answer is to say if a Tribe is at or below 2.0x total leverage it's generally a safe place to be. TFA would also suggest an active debt management policy and capital investment are essential to managing financial risk. New or existing debt can be a great financial tool, but it can also cause significant problems if not utilized correctly. If your Tribe would find it useful to have TFA take a look at its financial situation, we would be more than happy to help out.

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