Investment Summary

Investment Thesis
I am issuing a sell recommendation of The GEO Group (NYSE: GEO) with a 12-month target price of $5.14. This represents a 14.48% downside from its February 25th closing price of $6.01.

Key Drivers
- Opposing Legislation
  - In early 2021, Biden issued an executive order which banned the renewal of the Justice Department’s contracts with private correctional operators. These contracts make up roughly 25% of GEO’s revenues.
  - Pushback and lawsuits targeting the use of prison labor threaten GEO’s operations. Prison labor helps private correctional facilities to operate at low costs compared to government counterparts.
- Declining Immigration
  - Illegal immigration to the U.S steadily declined in the last 10 years. This decline led to empty beds in ICE facilities. ICE will likely face budgetary cuts because these facilities are relatively empty. ICE is GEO’s largest customer, making up roughly 33% of revenue.
- Default Risk
  - GEO’s credit rating sits at CCC which suggests significant default risk.
  - Public scrutiny of private correctional facilities forced large lenders to distance themselves from these operators. This leaves fewer options for future financing. Additionally, GEO has a significant amount of debt maturing in the next 5 years, which they cannot refinance because of unsupportive financial markets.
  - GEO’s operations are expected to decline which further inhibit its ability to meet upcoming debt obligations.
  - GEO is highly levered compared to its peers which makes it inflexible to address upcoming debt maturities.

<table>
<thead>
<tr>
<th>Market Profile</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Price</td>
<td>$6.01</td>
</tr>
<tr>
<td>52 Week Range</td>
<td>$4.96 - 11.00</td>
</tr>
<tr>
<td>Market Cap</td>
<td>$784 mm</td>
</tr>
<tr>
<td>Revenue</td>
<td>$2256 mm</td>
</tr>
<tr>
<td>AFFO</td>
<td>$299 mm</td>
</tr>
<tr>
<td>Price / Earnings</td>
<td>11.3x</td>
</tr>
<tr>
<td>Price / Tang Book Value</td>
<td>14.7x</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>4.0%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>8.2%</td>
</tr>
<tr>
<td>Net Income Margin</td>
<td>3.4%</td>
</tr>
<tr>
<td>Beta</td>
<td>0.70</td>
</tr>
<tr>
<td>Debt / Equity</td>
<td>3.14</td>
</tr>
<tr>
<td>Credit Rating</td>
<td>CCC</td>
</tr>
<tr>
<td>EV / EBITDA</td>
<td>7.10</td>
</tr>
</tbody>
</table>

GEO Target Price ($)
Company Overview

The GEO Group (NYSE: GEO) specializes in ownership, leasing, & managing correctional, detention, and re-entry facilities. The company’s mission is to leverage public-private partnerships to provide high quality rehabilitation services. It was founded in 1984 by George Zoley who acted as CEO until June 2021, where he transitioned to executive chairman. GEO began as a C-Corp from its initial IPO in 1994, it later restructured to a REIT in 2013, then restructured back into a C-Corp in late 2021. The primary reason for this change is to address upcoming debt maturities.

Headquartered in Florida, the firm focuses domestically (~ 92% revenue), but also offers services in Australia, South Africa, and the U.K (~ 8% revenue). GEO’s customer base includes 27 states, 3 federal agencies, 5 international agencies, and over 12 State Department of Corrections. GEO owns, leases, and manages over 93,000 beds and 120 facilities. GEO’s has high quality contracts with government entities, features include: an average length of 7-10 years, fixed monthly payments, and an 85% customer retention rate.
Business Description

GEO’s revenue streams are categorized through its business services or through its structure. GEO offers 4 primary services: US Secure Services, GEO Care, International Services, and Facility Construction & Design. US Secure Services (~67% of revenue) owns/leases/manages correctional facilities through public-private partnerships for the Federal Bureau of Prisons, U.S Marshals Services, U.S Immigration & Customs Enforcement, and several states. Under its management, GEO provides secure custody, health care, food, and maintenance services. GEO Care (~24% of revenue) focuses on community reentry and rehabilitation services such as temporary housing, counseling, educational programs, electronic monitoring, and employment assistance. International Services (~9% of revenue) is GEO Secure services marketed in South Africa, Australia, and the U.K. The Facility Construction & Design (~0.7% of revenue) segment contracts with local, state, and federal agencies. This segment used to be much larger, peaking at roughly 12% of total revenue in 2016. Lack of government funding on building new correctional facilities led to this segment decline.

GEO’s former REIT structure was split into 3 main divisions: owned/leased facilities, managed-only facilities, and non-residential/other. Most owned/leased facilities include management services mentioned above. Owned/leased facilities (~59% of revenue) and managed only facilities (~25% of revenue) include penitentiaries, detention centers, and rehab centers. Non-residential/other (~16% of revenue) includes day reporting centers and electrical monitoring. Day reporting centers is where offenders meet their probation officer. Non-residential/other also includes GEO’s subsidiary BI Incorporated that provides technology such as ankle monitors for those on parole, probation, and in the immigration process. GEO pairs this technology with supervision services. Non-residential/other has the highest net operating margins of 49% compared to owned/leased facilities with 28% and managed only facilities with 14%.
Management & Governance

Jose Gordo
GEO Group appointed Jose Gordo as Chief Executive Officer in July 2021. Prior to this position, Gordo from October 2019 served as an Independent Director and Chair of the Nominating & Corporate Governance Committee. His expertise includes Business Management, Corporate Finance, and Corporate Law. He holds a J.D degree from Georgetown University, acted as a Managing Director for a Private Equity Firm, and was a Partner at a Law Firm. Gordo’s roots to GEO date back 20 years, when he provided legal counsel to the firm.

George Zoley
George Zoley is the Executive Chairman, Founder, and former CEO of GEO Group. He served as CEO since the company’s IPO in 1994. His new position as executive chairman includes a 5-year contract with subsequent 1-year renewals. The transition to Executive Chairman allows Zoley to focus on strategic planning and lets Gordo with the rest of senior management run the day-to-day operations.

Transition to C-Corp
In December 2021, GEO transitioned to a C-Corp from a REIT with unanimous approval, effective at end of fiscal year 2021. This plan includes dividend termination for the near future. The structure change helps to address financial concerns regarding GEO’s outstanding debt. Principal debt is difficult to reduce as a REIT because at least 90% of earnings must be paid out as dividends. The change to a C-Corp provides more earnings flexibility, which GEO can use to reduce its debt obligations. The switch to a C-Corp also changes GEO’s tax structure. REIT’s typically pay little to no income taxes on the corporate level because they only pay income taxes on remaining retained earnings after dividend payments. Although GEO now has more flexibility to repay its debt, its overall earnings will likely decline because of higher effective tax rates. Additionally, the corporate structure change brought a $75 million onetime tax expense.

Institutional Ownership
Institutions hold roughly 84.32% of GEO’s shares. The largest owners Vanguard Group (~17.3%) and BlackRock (~14.7%) both decreased their holdings by roughly 2% in the last 3 months.
Industry Analysis

Overview
The correctional facility industry is declining/stagnant. Revenue grew at a 4.4% CAGR from 2016-2021, reaching $9.3 billion, but it's projected to decrease 2% a year until 2026 for several reasons. Biden's early 2021 executive order prevents the renewal of the Department of Justice's private prison contracts. The Department of Justice includes the Bureau of Prisons, and the U.S Marshals Services which makes up roughly 25% of industry revenue. The remaining revenue comes from States/Local (~50%) and U.S Immigration and Customs Enforcement (~25%). California’s late 2019 ban of private prison contract renewal also drives the industry decline. Most California contracts expire within the next 3 years with the latest expiring in 2028. California is the largest correctional spender in the U.S so this ban poses a major threat. They allocate over $8.5 billion a year which is more than double the second highest spender, Texas at $4 billion a year. Expenses in the industry also rose in the last two years due to COVID mandates to reduce infection amongst inmates. These expenses include ventilation upgrades, sanitary equipment for inmates, and overall frequent facility cleaning.
Industry Analysis

Correctional Population

Falling incarceration rates and crime rates in the U.S influences the industry decline. The U.S crime rate fell on average 3.7% a year since 2016, with an expected decline of at least 3% a year until 2026. The aging U.S population is a primary contributor to this decline since the National Institute of Justice says most crime occurs during the late teens and early twenties. Incarceration rates, which is directly tied to crime rates is also declining. The incarceration rate in the U.S fell on average 2.7% since 2016 and is predicted to decline at least 5% annually until 2026. Governmental efforts to combat overcrowding prison populations also impact incarceration rates. The 2018 First Step Act aims to reduce the federal inmate population and provides greater leniency on drug convictions. Declining incarceration rates hurt private prison operators because they collect less for housing inmates. 35% of private prisons only collect fees from occupied beds, thus declining inmate populations result in fewer fees collected. The remaining 65% of private prison contracts contain minimum occupancy clauses between 80% - 100%, meaning that the government pays for 80%+ of the total beds in facilities even if they are empty. Falling correctional populations benefit private prisons with minimum occupancy clauses because they do not have to pay the variable costs to upkeep empty beds, however, the benefit is short lived. In future contract negotiations, government clients will be reluctant to pay high minimum occupancy rates if the inmate population continues to fall.
Industry Analysis

Market Share
The private correctional facility industry is relatively concentrated. The 3 main players: Corecivic Inc, Geo Group, and MTC control 41% of the market. Concentration was higher in 2016 when these firms controlled 58% of the market. GEO’s control fell the most, they held roughly 20% of the market in 2016, to 12% now. Although these large corporations lost market share, the overall industry has fewer competitors in the same time span. The overall number of companies in this industry fell 6.5% annually from 2016-2021 and is expected to fall 3.1% annually to 2026. The industry decline forced smaller competitors to move out or be acquired. The primary source of competition is from government agencies that plan to run the facilities in-house instead of outsourcing due to new legislation. 

The large players competitive advantage derives from their ownership of facilities. Their leases often include clauses that reduce rent payment if the client also hires them for management services. This makes it cheaper for the client to have the same firm as a landlord and as a service provider. Government ownership of facilities eliminates the leverage that larger players have when competing for management contracts.

Correctional Facility Market Share (2016)

Correctional Facility Market Share (2021)
Key Drivers / Industry Analysis

Opposing Legislation
In early 2021, Biden released an executive order that banned the renewal of the Justice Department’s private prisons contracts. The Justice Department includes the Bureau of Prisons and U.S Marshals Services. This makes up roughly 25% of Geo Group’s revenue. 26/31 contracts with the Justice Department expire in the next 3 years, the rest expire in the next 5 years. Roughly 25% of GEO’s revenue will disappear by 2026 if the executive order isn’t overturned. executive order isn’t overturned. Additionally, recent pushback against the use of prison labor significantly threaten GEO’s operating margins. Private operators often outsource duties such as maintenance, food preparation and laundry to prisoners. This helps them operate at lower costs. Detainees are paid less than a $1 a day for their labor, if paid at all. Public scrutiny of this practice has increased recently. GEO Group lost a lawsuit in 2021 because it paid detainees $1 a day for their labor in its Washington Ice Processing Center. The Washington court issued a fine of $23 million and forced GEO to pay the state minimum wage of $13.69 an hour. GEO’s operating margins will deteriorate if this travels to large correctional states like Texas, who made $84 million off free prison labor in 2017.

Declining Immigration
Declining illegal immigration threatens GEO because ICE is its largest customer (~33% revenue). Unauthorized immigration steadily declined in the U.S for the last 10 years at a CAGR of -1.4%. The Daily ICE Detention Population sits at 20-year lows because the pandemic forced ICE to take less immigrants to adhere to social distancing guideline. Additionally, the Biden administration cares less about immigration compared to the Trump administration. Falling daily detainee populations correlates to empty facilities. This benefits GEO in the short term because most of their contracts contain minimum occupancy clauses of 80-90%. Meaning they still receive fees for 80% of beds even if only 40% are occupied. The Trump administration’s vast funding on immigration enabled ICE to pay high minimum occupancy rates. The Government Accountability Office found that the number of guaranteed beds by ICE grew 45% during the Trump administration. Low detainee populations hurt GEO in the long term because ICE will likely be reluctant to pay high minimum occupancy rates. ICE’s declining budget also makes it more reluctant to pay high minimum occupancy rates.
Key Drivers / Financial Analysis

Default Risk
The GEO Group has over $3 billion in debt maturing within the next 5 years, which poses a major concern for three reasons: declining operations, a lack of available funds, and unsupportive financial markets. GEO’s S&P credit rating fell from B to CCC in the last year.

As mentioned previously, Biden’s executive order essentially cut 25% of GEO’s revenue in the next 5 years. Additionally, declining incarceration rates, falling illegal immigration, and push back against prison labor threaten GEO’s operations. The “Bed Occupancy & Contract Retention Rates” chart shows how essential metrics for operational health have sharply declined in the last 5 years. These metrics will likely remain low because of the negative industry outlook.

GEO’s former REIT structure forced them to pay out 90%+ of earnings as dividends. Instead, GEO’s dividend payout ratio exceeded 100% since it became a REIT in 2013. This unsustainable practice led to a sharp decline in retained earnings, illustrated to the right. Additionally, GEO’s (Net Debt / FCF) ratio is around 21, making it extremely difficult for GEO Group to meet its debt obligations organically. Lack of self-sufficiency will force GEO to seek assistance from financial markets.

In prior years, GEO Group refinanced debt as it neared maturity; however, this is no longer feasible. In 2019, many major banks announced that they will stop financing private prisons in the future. These banks provided the majority of GEO’s loans (specific amounts not publicly available). Additionally, if GEO Group manages to issue new debt, it will have extremely high yields because of rising treasury rates, a poor credit rating, a depressed stock, and significant leverage (Net Debt / EBITDA of 6 and D/E of 3). With a lack of financing options to meet upcoming debt obligations, GEO Group faces significant default risk.
Financial Analysis

Annual Revenue
GEO’s annual revenues are relatively stagnant. They grew at a CAGR of 4.9% during the Trump administration, peaking in 2019 at roughly $2.5 billion. 2019 was a record year because apprehensions at the southwest border hit 12-year highs. An increase in families seeking asylum and the Trump administration’s pressure to combat illegal immigration heightened arrests. Revenues slightly fell during the pandemic because illegal immigrants were detained for a shorter period to reduce the spread of the virus.

Net Income Margin
GEO’s net income margins steadily declined in the past 6 years because of increasing SG&A expenses and property expenses.

Debt-to-EBITDA
GEO’s Net Debt to EBITDA ratio floated between 5.5-6 in the last 6 years. This is the average for most REIT’s, whereas the average for C-Corps and GEO’s largest competitor CoreCivic is around 3. GEO will either have to significantly increase EBITDA or decrease its debt, to be in line with its competitors. The Net Debt / (EBITDA – CapEx) ratio fluctuates between 6-9, peaking at 14 in 2018. This metric better represents GEO’s performance because the industry requires large capital expenditures to maintain and upgrade facilities. GEO decreased capital expenditures in the past year for liquidity purposes; however, this provides a temporary solution because buildings will require significant repairs at some point.
Financial Analysis

**Debt-to-Equity and Return on Equity**

The chart on the right compares GEO’s Debt-to-Equity to its Return on Equity. GEO is highly levered compared to its main competitor CoreCivic who has a D/E ratio of 1.2. GEO’s leverage increased steadily the past 6 years, yet its ROE remained stagnant and even dropped significantly the last 2 years, falling from 16% to 8%. In theory, leverage boosts equity returns, yet it hasn’t for GEO and has strained it financially. Leverage failed to significantly amplify returns during relatively prosperous periods between 2015-2019. GEO’s capital structure poses little to no benefit to shareholders because the increased risk has not amplified the reward.

**Levered Free Cash Flow**

Levered Free Cash Flow measures cash flow available to equity investors. It’s nearly identical to the unlevered FCF formula but adjusts for interest payments. Levered FCF fluctuated between 2015 and 2019. It flattened out in the past 2 years because management reduced capital expenditures to help meet debt obligations.

**Earnings Per Share**

GEO’s EPS declined at a 12% CAGR for the past 6 years. The potential use of equity financing to address debt obligations would further reduce GEO’s EPS.
Valuation

**Common Inputs**
I chose a 1st stage growth of -5.59% for 5 years that represents a CAGR of a 25% decrease in revenue in the next 5 years. The final stage growth of -1.5% represents declining immigration, reduced ICE funding, and public pushback against private prisons. In perspective, a -1.5% decline per year for 20 years after the initial -5.59% decline, drops GEO’s revenues from $1692 mm to $1250 mm. I used 4.5% for the market risk premium which is the historical average.

**Free Cash Flow to Equity Model**
For the FCFE model, I took the net new debt 3-year average because the LTM net new debt produced a negative FCFE. I used 21% for the effective tax rate (corporate tax rate) instead of GEO’s historical rate because they had significantly lower taxes as a REIT.

**Free Cash Flow Model**
For the FCF model, I took the 5-year average cash balance because GEO’s LTM cash balance jumped nearly 100% from 2020 and jumped over 1500% from 2019.

**Dividend Discount Model**
At the end of FY 2021, GEO announced that they would discontinue their dividends indefinitely to address upcoming debt obligations. For this model, I predicted a future dividend in 5 years and then discounted it to get the present value. To get the dividend of $0.14 in 5 years, I decreased net income by 25%, then multiplied it by the market average payout ratio (30%), I then divided that by the current shares outstanding. From the model, I calculated a target price of $1.93 in 5 years. I then discounted this back 5 years using the cost of equity.

<table>
<thead>
<tr>
<th></th>
<th>Price</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free Cash Flow to Equity Model</td>
<td>$5.90</td>
<td>33.33%</td>
</tr>
<tr>
<td>Free Cash Flow Model</td>
<td>$8.08</td>
<td>33.33%</td>
</tr>
<tr>
<td>Dividend Discount Model</td>
<td>$1.43</td>
<td>33.33%</td>
</tr>
<tr>
<td>Final Price</td>
<td>$5.14</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Final Valuation**
I took the price from each model and created an equal weighted average to get my target price of $5.14.
Investment Risks

Acquisition Target

Geo Group may be an acquisition target due to recent events that have depressed its stock price. The typical acquisition premium is around 20-30% which poses a major threat to my thesis. GEO Group is the 2nd largest company in the industry so the chances of an acquisition/merger are slim. Additionally, GEO’s current leverage makes an LBO undesirable. I believe the most likely outcome is that Geo Group sells off a part of its business. For example, GEO could sell off its electronic monitoring services business, BI Incorporated, which is the largest in the U.S. This segment acts as a subsidiary, so it’s reasonable that a competitor or a private firm would look to acquire it.

Political Risk

Court rulings in favor of The Geo Group will have an adverse effect on this position. For example, in October 2021, a judge overturned a 2019 California law which banned the use of private ICE immigration centers. The court deemed that this law was unconstitutional because it conflicts with federal power and homeland security. Geo Group’s stock rose over 12% in the same week the news came out. The overruling of the California law had a significant impact because California spends the most out of all states on correctional services. Biden’s executive order which banned the DOJ’s private prison contracts may be overturned because it falls under the realm of “national security.”

Growth in Monitoring Business

GEO’s electronic monitoring business, BI Incorporated, is the largest in the country. This segment generated roughly $280 million in 2021 and has grown at a CAGR of 9.49% in the last 5 years. It’s GEO’s most profitable segment, boasting 45% operating margins. Additionally, no current or pending legislation directly affects BI Incorporated. If GEO Group shifts its operational focus to this segment, it may pose a threat to my thesis.
References

- CapiQ
- GEO Group
- https://www.fool.com/investing/2021/08/04/why-geo-group-is-soaring-today/
- https://www.prb.org/resources/u-s-has-worlds-highest-incarceration-rate/
- https://www.forbes.com/sites/stuartanderson/2021/03/10/illegal-immigration-in-america-has-continued-to-decline/?sh=49f91c724e14
- https://www.texasobserver.org/penal-system-slavery-unpaid-labor-texas/
- https://www.npr.org/2021/04/01/982815269/beyond-the-border-fewer-immigrants-being-locked-up-but-ice-still-pays-for-empty-
- https://news.littlesis.org/2019/08/14/private-prisons-now-face-87-4-financing-gap-as-banks-continue-to-flee-industry/
- https://www.pewresearch.org/fact-tank/2020/03/02/how-border-apprehensions-ice-arrests-and-deportations-have-changed-under-trump/
- https://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html
- https://www.gurufocus.com/term/wacc/GEO/WACC/The+GEO+Group+Inc