TRIBAL FINANCIAL ADVISORS
INCORPORATED

Providing Tribes Clear Solutions in an Ever Changing Economic Environment

TFA Monthly Newsletter

April 2014

Headline News:

3/5/14: Five Major Indian Gaming Issues To Watch In 2014 (mondaq.com)

3/11/14: Washburn Approves Kaw Nation Land For Gaming (indiancountrytoday.com)

3/24/14: Native American Moapa Tribe And First Solar Begin Construction Of 250MW Project (pv-tech.org)

3/28/14: Proposed $34M Casino Would Make $55M Impact On Local Economy (prairiebizmag.com)

3/30/14: Armenta: Wider Gaming Floor, Expanded Hotel Under Consideration (lompocrecord.com)

3/31/14: John Ferak: New Study Spotlights Pluses, Minuses For Indian Casinos (postcrescent.com)

Subordinated Debt: What Exactly Is It?

by Jeffrey Heimann

Subordinated debt, sometimes called "junior debt", is a very important and useful financing tool, particularly for raising debt in connection with casino developments and expansions. While subordinated debt is useful across many industries and sectors, it is particularly important for Tribes for several reasons: (a) the senior debt lender universe for Tribes is smaller than for many other sectors; (b) banks and other providers of senior debt typically require lower leverage ratios for Native American borrowers than they due for corporate borrowers; and (c) because Tribes cannot raise equity, most new Tribal casino developments rely on subordinated debt to essentially act as a proxy for equity capital to round out the necessary dollars to complete the casino development.

The word "subordinate" means "placed in or occupying a lower class, rank or position." This type of debt is described as subordinated because the lenders have a subordinate status in relationship to the senior debt lenders. In other words, senior lenders would benefit from their priority position in any downside scenario (i.e., a credit default or loan restructuring) relative to the junior lenders. For example, if a borrower were to fall out of compliance of a required credit ratio that resulted in an event of default, the subordinated lender generally would have little to no rights until the senior lenders were paid off in full (or agreed to a restructured deal). Specifically, subordinated lenders typically have a binding legal agreement with the senior lenders to "standstill" and promise not to interfere until the senior lenders work out the situation with the borrower.

Because subordinated debt is repaid

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TFA will be attending NAFOA's 32nd Annual Conference - April 14-15. Please let us know if you will also be in attendance and would like to set up a meeting with TFA.

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after senior debts have been paid, and because the interest payable on subordinated debt typically cannot be paid unless the senior debt interest is paid first, it is more risky for the subordinated lender. As such, subordinated debt almost always has a lower credit rating than senior debt, and because of the lower credit profile, subordinated lenders almost always charge higher rates than those charged by senior lenders. Higher risk directly translates to a higher interest rate.

(One important exception to that is when a manager or developer partners with a Tribe and provides seed capital. In this case, the subordinated debt is often cheaper than the senior debt because the lender is benefiting from additional management and/or development fees and therefore their total return is much greater than the senior debt.)

Partly because of the higher return subordinate lenders benefit from, subordinate debt typically offers more flexible terms as compared to senior debt. For example, where a bank may limit a loan to 5 years, an institutional investor may allow for a 10-, 12- or even 15-year maturity. Also, while banks may require debt repayment of 10% to 20% of the initial loan amount each year, a subordinated lender may require 5% per year or less. In some instances subordinated lenders even allow for a "bullet" maturity (i.e., no annual debt repayment and instead the entire loan is due at maturity). Because of the more flexible repayment terms, subordinated debt is often preferred by Tribes. The reason for this can be seen with simple math and what it means for flexibility with transferring dollars from the Casino to the Tribe. For example, a bank loan at 5% interest that requires 20% debt repayment per year effectively requires 25% of the loan amount to be paid in debt service year 1. A subordinated loan with 12% interest and zero required debt repayment then may provide twice as much transfer flexibility. While this situation would result in more debt being outstanding for longer periods of time for a Tribe, it may also allow the Tribe to fund important and irreplaceable government programs and other social services.

As with many things, there is a time and place for subordinated debt. Knowing when and how to use it, and also picking the right subordinated lender, are very important to understand. Please feel free to call us with any questions on this important tool.

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