Letter from the Editors

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Prison REITs

Companies that manage prisons must not only be concerned with the rights of prisoners but also with the rights of shareholders. Although the two sets of rights are not dichotomous it requires insightful management to keep the interests of owners, prison authorities and inmates aligned.

As of March 5th, 1998 the Federal Bureau of Prisons (BOP) had under its governance a prison population of 115,835. Of this number 12,271 were housed in privately managed facilities. The BOP is projecting that by the year 2003 the number of prisoners for whom it will be responsible will grow by one third. Imprisonment rates (number of sentenced prisoners over 100,000 U.S. residents) among males increased by 43% between 1990 and 1996. For females the increase was 65%. As of December 31, 1997 State Prisons "were operating at between 15% and 24% above capacity, while Federal prisons were operating at 19% above capacity" (August 1998, Bureau of Justice Statistical Report by Darrell K. Gillard and Allen J. Beck).

Privatization of prison services like any public service can only offer public authorities value for money if the private sector can provide the same or better service than the public sector at a lower cost when calculated over the appropriate time frame using the correct discount rate. Higher degrees of management inefficiency associated with public management of a prison or prison system offers the private sector more degrees of freedom to pass savings back to the public and profits forward to shareholders.

"Experience at some federal agencies and the local government level shows that private prison companies can construct or manage prisons for as much as 20% less than government built and operated facilities. The U.S. Marshall Service contracts with private firms to run some minimum security facilities. Some two-third of detention centers at all levels of government are privately run. The Federal Bureau of Prisons has not kept pace. . .

The President's FY96 budget includes intentions to privatize the management of most future pretrial and minimum and low security facilities now under construction." (Testimony of Scott Klug, Congressman, House of Representatives, before House Budget Committee on Privatization, February 28, 1995)

Wackenhut Corrections Corp. (WHC) was awarded a contract by the BOP to operate the federal penitentiary in Taft, California. This contract is part of the five year privatization demonstration instituted by the 1997 Congressional appropriations bill. The contract term is for an initial three-year period and includes seven one-year extension options. The National Capital Revitalization and Self-Government Improvement Act of 1997 directs the BOP to assume responsibility for all District of Columbia sentenced felons by October 1, 2001. By December 31st, 1999 two thousand District of Columbia felons must be housed in privately operated correctional facilities.

"The Virginia Corrections Private Management Act allows use of private prisons only if it provides a cost-benefit to the Commonwealth. To date, Virginia has initiated two medium security prison projects utilizing private vendor initiatives. The Lawrenceville Correctional Center in Lawrenceville, Virginia will open in the Spring of 1998 and the Drakes Branch Correctional Center in Charlotte County, Virginia will begin construction in the spring of 1998. In both facilities, it is estimated that after the first year of operations the annual private cost of operating these facilities will be over $2,000 less per inmate than if operated by the state." (Shirley Ybarra, Deputy Secretary of Transportation for the Commonwealth of Virginia, Congressional Testimony, House Committee on Government Reform and Oversight Subcommittee on Government Management, Information, and Technology, September 29, 1997).

The two leading private suppliers of correctional and incarceration services to the U.S. market are Wackenhut Corrections Corporation (WHC) and Corrections Corporation of America (CCA). According to WHC's 1997 annual report it had contracts to operate 30,144 prison beds in North America, Europe and Australia. CCA's annual report states that the company has contracts to manage 68 correctional facilities with an "aggregate design capacity of 54,944." WHC's share of the U.S. cor-

rections facilities market is approximately 23% and CCA's share of the U.S. market is 53%. The general model on which both companies base their operations is to enter into contracts with local, state and federal prison authorities for the provision of prison services. The contract may call for the design, construction, operation, or financing, of a facility or any combination of these four elements.

"Contractually, the transaction is structured as lease/purchase financing wherein the government partner executes a long-term lease (commonly 20-30 years) with CCA, which, in turn, secures or arranges financing based on the lease obligation. The financing, and subsequently the lease rate, includes all project-related costs and expenses. This way, the government partner typically does not incur any additional fees or any out-of-pocket, up-front project development costs. These types of financing are often referred to as "off-balance sheet". The fixed annual expenditure (the lease cost) is generally then subject to annual appropriations and generally is not counted as "debt" on the balance sheet of the government partner. Based on this structure, the government partner can avoid seeking a voter referendum to approve the transaction as they are not incurring additional debt. A major benefit of this approach is that the projects can be financed at interest rates competitive with the rates the government partner would be able to secure under their own traditional financing vehicles (such as general obligation bonds). Additionally, the government partner does not need to incorporate the lease payments into their fiscal budget until the facility is completed and ready to receive inmates. In traditional bond financing, the government starts to accrue interest liability when the bonds are issued, well before construction even begins. In a design/build/finance approach, the annual lease expense allocated to the government partner's budget can be 10%-20% less than the principal and interest which must be paid on a bond issuance. The end result is that the government partner obtains a new facility designed and built to its specifications in a much more cost- and time-efficient manner" (Testimony of J. Michael Quinlan, Chief Executive Officer of CCA Prison Realty Trust, before the House Subcommittee on Public Buildings and Economic Development February 26, 1998).

Both CCA and WHC employ real estate investment trusts "REITs" to refinance their portfolio of correctional facilities. CCA and WHC, prison management companies, sell correctional facilities to REITs and lease them back. Facilities are also purchased by the REITs directly from the public sector and leased back to the responsible prison authority. Generally the leases are triple net leases requiring the lessee to pay all operating expenses, taxes, insurance, structural, non-structural repairs and other costs. In July of 1997 CCA Prison Realty Trust (PZN) completed an initial public offering of common shares. On April 28, 1998 Correctional Properties Trust (CPV), the REIT set up by WHC, went public. As of August 31st 1998 the market capitalization of PZN and CPV were $384 million and $101 million respectively.

Proceeds from PZN's IPO were used to purchase nine correctional facilities owned by CCA. PZN then leased back the nine properties to CCA via 10-12 year triple net leases. Upon mutual consent of CCA and PZN the leases allow for three five-year extensions. In addition to financing the purchase of the nine original correctional facilities, PZN used proceeds from its IPO to purchase call options on an additional five correctional or detention facilities. The options expire three years after the acquisition by CCA of the facilities. The strike price of the options is CCA's development, construction, and equipment costs plus 5%. PZN has also entered into an agreement that gives it the right to purchase at fair market value and leaseback to CCA at fair market rental rates correction or detention facilities acquired by CCA. The agreement extends for three years from the time the facilities begin to receive inmates. Proceeds from CPV's initial public offering were used to purchase facilities and options on facilities from WHC. CPV leases the facilities back to WHC under long term triple net leases.

Employing a REIT to refinance correctional facilities allows both CCA and WHC to separate the construction and operational management from arranging and securing long term financing. Investors who buy shares in either CCA or WHC are buying into a service company, while investors who buy shares in either PZN or CPV are investing in the performance of long term real estate leases. Since investors can combine shares of a REIT that leases correctional facilities and the shares of a company that manages the leased properties in proportions that achieve their desired expected risk/return profile, the separation adds value by offering investors more portfolio choices than if the management and financing functions were combined. Unbundling operational management and financial management is motivated by the federal tax code that offers a corporation, trust or association exemption from federal income taxes if it qualifies as a REIT. The criteria that must be met to be classified as a REIT for federal income tax purposes relate to the composition of assets, sources of income and distribution of income. In simplified terms a REIT must derive 75% of its gross income from real estate investments and must distribute 95% of its taxable income to shareholders. Exemption from federal income taxes lowers the required rate of return the REIT must earn on its assets. In other words REIT status is valuable because it lowers the cost of capital (for the complete and detailed definition of a REIT see IRS code 856 and 857). Of course the 95% earnings pay out forces a REIT to tap the capital markets on a regular basis to fund growth. Investors who prefer capital gains relative to income will discount REIT shares.

On April 20th, 1998 CCA and PZN announced their

intentions to merge. The deal is expected to be closed in January of 1999. PZN will be the surviving entity. Management of the facilities owned by PZN will be assumed by three newly formed private companies that will continue to operate under the name Corrections Corporation America. One of the new management companies will be responsible for adult prisons not owned by CCA, one will be responsible for jail and detention facilities not owned by CCA and the third will manage properties already owned by PZN and CCA and future properties acquired by PZN. PZN will own 95% of the first two management companies and 9.5% of the third.

From April 13th, 1998 (one week before the merger announcement) through September 18th, 1998 the total return on the New York Stock Exchange Composite Index (NYA), on WHC's common stock, and on CCA's common stock has been: -11.73%, -19.62%, and -52.94% respectively. The total return on the Standard & Poor's REIT Index, on CPV's common stock and on PZN's common stock for the same period, has been -20.12%, -23.38% and -47.50% respectively (source Bloomberg L.P.). In addition to the decline in CCA's and PZN's value relative to the broader market and to WHC and CPV, terms of the merger announcement have motivated a number of shareholder lawsuits against CCA.

What are the benefits of this transaction? Investors had the option of buying shares of PZN and CCA prior to the transaction. A merger reduces portfolio choice by eliminating the opportunity of investing in the service side of the business without taking a position in the REIT dimension. Shareholders of CCA, a growth oriented service company, are being pulled into a finance company that is required to pay out at least 95% of its taxable income to shareholders. Shareholders in PZN will still participate in the value of the management side of the business through PZN's ownership interests in the privately held CCA.

A tax arbitrage is one of the driving forces behind the transaction. The ability to place more income from new and existing contracts signed by CCA under the REIT tax shield, lowers the cost of financing government contracts to design, build, and own correctional facilities. Lower funding costs can be translated into more competitive bidding.

We invite experts from the fields of accounting, finance, law and real estate to submit a detailed analysis of the initial PZN public offering and the subsequent merger between PZN and CCA to the following issue of ***The Arbitrageur*** **(www.the-financier.com)**. We are interested in publishing a case study that examines the value of the merger to the inside and outside shareholders of PZN and CCA. Does the merger between PZN and CCA violate shareholder rights? Will WHC follow CCA's lead and merge with CPV?

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