

# Paying For School: An Overview of Charter School Finance

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## **Executive Summary**

This paper examines the current state of the market for charter school finance and will focus specifically on programs and financing structures for school facilities. A review of existing research on charter school finance as well as a series of interviews with leading practitioners – from the public, private, and nonprofit sectors – reveals that:

- The charter school industry in the United States has shown tremendous growth in the past fifteen years, with the numbers of schools and students enrolled in charter schools all having increased exponentially. To encourage the flow of capital from lenders and investors to charter schools, the public and private sectors have designed and implemented new subsidy programs – at the federal, state, and local levels – to stimulate new, creative financing structures.
- One issue that has hampered schools' ability to grow is the lack of public funding and private-sector involvement in facilities financing for charter schools. Government agencies at the federal, state, and local levels have recently adopted policies to address this problem of inadequate access to capital.
- Among these recent policy innovations is the creation of the United States Department of Education's Credit Enhancement for Charter Schools program, which provides full or partial guarantees (of principal and interest) to lenders whose funds are used to finance the construction or renovation of facilities for charter schools.
- Some of the best practices for facilities financing for charter schools described in this paper include: specialized underwriting tools, state intercept mechanisms, charter management organizations and development intermediaries, and moral obligation pledges by state and local governments.

## Background

The Charter school industry has undergone substantial growth since the early 1990s. Charter schools are publicly funded, privately managed schools that operate under a contract, or “charter,” with state-approved entities, such as school districts, county and state offices of education, and, in some states, state chartering boards, according to a report by the Low Income Investment Fund (LIIF).<sup>1</sup> In 1992, Milo Cutter founded City Academy in Minnesota, the nation’s first charter school.<sup>2</sup> As of April 2008, forty states and the District of Columbia approved charter school laws for approximately 4,100 charter schools nationwide with an estimated 1.2 million students.<sup>3</sup>

Charter school finance is a nascent but quickly growing industry, marked by participation from federal, state, and local government entities, as well as community banks, commercial and investment banks, and nonprofit organizations around the United States. Because charter schools are authorized at the state and local levels, there are considerable variations in the timing of states adopted charter school laws at different times and with different direct funding. Tables 1 and 2 list the first ten states and the most recent ten states (including the District of Columbia) to authorize charter schools; and also show the number of schools authorized:

*Table 1 – States with Greatest Numbers of Charter Schools*

State	# of Schools in Academic Year '06-'07	Per Pupil Match Rate for Operations	Year of State’s First Charter School Opening for Operations
California*^!	621	69%	1993
Arizona*	469	76%	1995
Florida*	355	69%	1996
Ohio^&	310	53%	1998
Michigan	230	65%	1995
Texas&	189	72%	1996
Wisconsin	188	72%	1994
Colorado*&	133	70%	1993
Minnesota*	131	94%	1992
Pennsylvania*	120	60%	1997

\* State offers per pupil funding stream for facilities (per LISC 2007 charter school facilities landscape)

^ State has authorized some sort of grant funding for charter school facilities

! State has publicly funded loan programs for charter schools

& State offers some sort of credit enhancement program

\*\* In the above tables, the “Per Pupil Match Rate for Operations” is shown as a percentage (i.e. the percentage of funding allotted on a per pupil basis to students in charter schools as compared with funding allotted to district public school students).

*Source: The Center for Education Reform<sup>4</sup>*

Table 2 – States with Lowest Number of Charter Schools

State	# of Schools in Academic Year '06-'07	Per Pupil Match Rate for Operations	Year of State's First Charter School Opening for Operations
Mississippi	1	60%	1998
Wyoming	3	51%	2002
Virginia	3	60%	2001
New Hampshire	8	37%	2004
Iowa	9	77%	2004
Rhode Island <sup>^</sup>	11	85%	1997
Tennessee	12	94%	2003
Oklahoma <sup>^</sup>	15	57%	1998
Arkansas	16	64%	2000
Connecticut <sup>^</sup>	16	71%	1997

<sup>^</sup> State has authorized some sort of grant funding for charter school facilities

Source: National Alliance for Public Charter Schools<sup>5</sup>

The tables clearly show that the ten states with the country's largest numbers of charter schools were "early adopters" of legislation authorizing charter schools. Another notable point from these data is the extent to which various states have approved programs to fund charter school facilities and operations. Of the ten states with the most charter schools, eight have at least one program to assist with facilities finance, including grant or loan programs. However, of the ten schools with the fewest charter schools, only three had programs for charter school facilities financing. Some municipalities have emerged as more "charter friendly," and the Table 3 below shows the cities that have the greatest number of students enrolled as a percentage of total enrollment.

Table 3 – Metro Area Data

Community	Charter Market Share	Charter	Non-Charter	All
1. New Orleans, LA	57%	14,822	11,343	26,165
2. Southfield, MI	27%	3,565	9,426	12,991
Dayton, OH	27%	6,036	16,272	22,308
Washington, DC	27%	19,924	55,164	75,088
3. Pontiac, MI	23%	2,687	9,003	11,690
Youngstown, OH	23%	2,615	8,835	11,450
4. Detroit, MI	20%	29,455	117,598	147,053
Kansas City, MO	20%	6,084	24,610	30,694
5. Toledo, OH	18%	6,356	29,368	35,724
6. Chula Vista, CA	17%	4,693	22,198	26,891
Cleveland, OH	17%	11,573	54,814	66,387
Cincinnati, OH	17%	6,846	33,935	40,781
Milwaukee, WI	17%	15,825	78,603	94,428
7. Buffalo, NY	16%	6,538	34,589	41,127
Dearborn, MI	16%	3,487	18,529	22,016
8. Oakland, CA	15%	7,208	39,804	47,012
Brighton, CO	15%	1,751	9,885	11,636
Albany, NY	15%	1,505	8,603	10,108
St. Louis, MO	15%	5,405	31,691	37,096
9. Minneapolis, MN	14%	5,854	36,337	42,191
10. Camden, NJ	13%	2,313	15,244	17,557
St. Paul, MN	13%	6,014	40,034	46,048
Philadelphia, PA	13%	26,834	179,376	206,210
Columbus, OH	13%	8,312	55,699	64,011
Vista, CA	13%	3,487	23,447	26,934
Saginaw, MI	13%	1,456	9,934	11,390
Mohave County, AZ	13%	3,572	24,383	27,955
Napa Valley, CA	13%	2,219	15,199	17,418
Appleton, WI	13%	1,915	13,328	15,243

Source: National Alliance for Public Charter Schools

Ray Budde, a professor at the University of Massachusetts, Amherst, first suggested the idea for a “charter” school in 1988 and was a leading advocate for charter schools in the late 1980s and early 1990s.<sup>6</sup> Budde’s paper “Education by Charter: Restructuring School Districts” outlined the steps that school districts and their administrators would need to take to implement charter schools locally.<sup>7</sup> Another early advocate of charter schools was Albert Shanker, then president of the American Federation of Teachers, who suggested that schools or groups of teachers should be given a charter for a certain period of time: “The school could be evaluated to see the extent to which it met its goals, and the charter could be extended or revoked,” as noted by Finn and Vanourek (2007).<sup>8</sup>

Chester Finn (2000) chronicles the recent history of education reform in the United States, starting with President Lyndon Johnson approving the Elementary and Secondary Education Act, which authorized greater funding for public schools. The thinking at the time was that more resources would lead to better

educational outcomes. Sociologist James Coleman, however, criticized the idea that more money for education would necessarily lead to better outcomes. Coleman wrote that it was more important to shift “policy attention from inputs (per pupil expenditure, class size, teacher salaries, and so on) to a focus on outputs.” The focus on outputs helped in the evolution of charter schools: “We want to swap red tape for results and that would become the exact theory of charter schools,” according to Finn.

Shober, Manna, and Witte (2006) also describe how the growth and development of charter schools was influenced by the movement toward accountability in education. The “need to hold schools and school districts accountable for academic performance challenged the local control prerogative.” And even though charter school laws vary by state, “all laws attempt to incorporate elements of flexibility and accountability. In exchange for considerable flexibility in operation and design of curriculum, pedagogy, and other aspects of running a school, charter operators agree to uphold certain standards of accountability through a written contract with an authorizing body.”

The clear emphasis on evaluation and understanding performance at the school and student levels is linked to Ray Budde’s original ideas for how to design charter schools. Among the goals that Budde listed in his paper, “Education by Charter,” was to “establish a program/services monitoring and evaluation system not under the control of those whose programs and services are being monitored and evaluated.”<sup>9</sup> Bryan Hassel (1998) further describes the value of accountability as it relates to the management and operation of charter schools: “Charter and voucher plans both hold schools accountable by giving families the choice of whether to have their children attend them. By tying funding to enrollment, both policies seek to induce schools to act in ways that families value. Those that fail to please families go out of business or are forced to rely on private tuition to support their operations.”<sup>10</sup>

## **The Charter School Facilities Problem**

Few charter schools own their own facilities. Jill Levine, director of School Services at the Illinois Facilities Fund (IFF), a Chicago-based CDFI that offers extensive real estate and financial services to charter schools and their management, stated: “In starting a school, the trend is to lease space at first and then after at least three years begin thinking about ownership.”<sup>11</sup> (Levine estimated that in Chicago, 16 percent of charter schools own their facilities.) According to the Educational Facilities Financing Center of the Local Initiatives Support Corporation, lack of appropriate facilities is a major obstacle: “While the financing opportunities available to charter schools for their facilities are increasing, the sector remains fragmented, with individual providers having different eligibility requirements, financial products and geographic markets. Obtaining access to financing is still difficult for smaller schools and those earlier in the charter school life cycle.”<sup>12</sup>

Charter schools do not have the direct taxing or bonding authority that traditional public schools use to pay for their facilities. According to Susan Harper of LIIF, “Most states still require charter schools to finance their start-up and facilities expenditures out of general operating revenues, privately raised funds, or partnerships with other organizations.”<sup>13</sup> Thus, unlike conventional public schools, which generally issue bonds to finance their facilities with large institutional backing, charters have not been able to execute similarly sized and rated transactions.<sup>14</sup>

From a financing standpoint, donors and lenders have perceived charter schools as highly risky because schools are often illiquid and lack operating history at the point when they need funds for operations or facilities. Although CDFIs are an important source of capital for charter school borrowers, Mary Tingerthal of the Housing Partnership Network noted that charter school loans are often too large for most CDFIs.<sup>15</sup> Also, schools often approach prospective lenders early in their operating history, when their creditworthiness is at its lowest. Table 4 below lists the risk factors that interviewees mentioned and that have been cited in the literature on charter school facilities underwriting.

Table 4 – Underwriting Risks

Risk	Risk Type	Consequences	Mitigating Factors
Charter Renewal	Operations	Default on hard debt; legal settlement	Many states are lengthening charter terms (e.g. 15-Year Term in AZ and no renewal required in UT)
Financial Mismanagement	Operations	Default on hard debt; legal settlement	Use of state intercept mechanisms to wire funds to bondholders or lenders; Increasingly savvy board members and school management teams; use of charter management organizations (CMOs)
Cost Overruns in Facilities Construction	Operations/Facilities	Decrease in liquidity and cash-on hand for operating expenses	Construction budgets for bonds financing charter school facilities include contingency reserve; use of DoE credit enhancement funds provides “first loss” position for lenders on facilities projects; Use of Development Intermediaries (e.g. Civic Builders) to manage construction and rehab
Variation in Per Pupil Match Levels	Policy	Decreases in Revenue and Net Income	Use of credit enhancement funds from DoE program or other subsidies (e.g. NMTCs); As tax-exempt organizations, schools can raise money through donations
Competition for Student Enrollment from School District	Policy	Decreases in Revenue and Net Income	School districts acting as “authorizer” of charter schools will support schools’ efforts to grow enrollment; As tax-exempt organizations, schools can raise money through donations
Instability in Capital Markets	Market	Higher interest rates on bonds; Difficulty for schools in obtaining financial guaranty insurance	CRA motivation for banks as lenders or investors; Bond buyers are “high yield” funds and returns on charter school bonds are high, despite low default and delinquency rates

For underwriters who are experienced in community development finance but not necessarily with education, charter schools present risks that do not exist in deals financing housing or community facilities. The major concern among lenders who are considering adding loans and bond purchases for charter school facilities as a line of business is the risk presented by charter renewal by a local or state authorizing agency. In seeking permanent financing for their facilities, schools frequently request terms and amortizations for loans or bonds that exceed the school’s charter. Consider, for example, a school in Chicago that may have been allocated a five-year charter term and is requesting bond financing after two years of operations. The school approaches lenders for the renovation of an existing building and requests bond debt – through 501(c)(3) bonds – with a term and amortization of fifteen years. For lenders, this situation poses substantial risks. If the school’s charter is not renewed in the fifth year, the source of repayment (per pupil revenues for school operations) will have been completely eliminated. In this scenario, a lender might be forced to foreclose on a charter school, which would be costly and have negative effects on the lender’s public relations image.

Today, however, lenders are more comfortable with reauthorization risk because the authorizing entities’ incentive is to ensure that students receive high-quality education, which means that schools that show improved student performance are likely to have their charters renewed. Additionally, to ease lenders’ concerns about reauthorization, state and local authorizing agencies are extending charter terms. Arizona, for example, now has a fifteen-year term for schools’ charters. This provides for longer terms and amortizations on loans and bonds without having to consider the reauthorization issue.

## Addressing the Problem

Given the scale of the facilities financing problem and the newness of this field, a number of strategies have been employed to pay for teaching space. One of the earliest approaches was the use of debt financing from CDFIs, according to Judith Kende, director of the New York region for LIIF.<sup>16</sup> These funds were used for working capital as well as tenant improvements and facilities. Elise Balboni, vice president of Education Programs for the Local Initiatives Support Corporation, echoed that sentiment, stating that “CDFIs were a ‘good fit’ as financiers of charter schools because they have a community focus and are located in low- and moderate-income communities.”<sup>17</sup> Aside from debt made available by CDFIs, early schools relied on grant funds from foundations and wealthy philanthropists as well as retained earnings to fund program and facilities expansion. Other financing tools as well have gained prominence in recent years.

## *Bonds*

To date, charter schools have been able to receive debt financing for facilities from CDFIs, commercial banks, state and local government loan programs, and bond purchases by municipal bond funds. According to Russ Caldwell, senior vice president of D. A. Davidson, an investment bank based in Montana, commercial or investment bankers did not address the issue of how to finance charter schools until 1995 or 1996, four years after the City Academy had opened its doors in Minnesota.<sup>18</sup>

Caldwell began working on 501(c)(3) bond finance programs in the mid-1990s and has since completed approximately 85 bond issuances for charter schools, totaling \$800 million in par value. According to Caldwell, between 350 and 400 schools (about 9 to 10 percent of all schools) have been able to complete bond financing to raise capital in transactions such as private placement or negotiated sale in the general market. Such bond financing provides a source of funds for schools to acquire or build out their existing facilities and make room for additional students. Mary Tingerthal, president of Capital Markets Companies for the Housing Partnership Network, said that bonds are a good finance fit because “charter schools tend to want long-term financing for their buildings, with the predictability of a fixed payment.”<sup>19</sup>

For these transactions, bonds are issued by a state or municipal authority and purchased by bond buyers as a negotiated sale or private placement. Thomas Nida, executive vice president for United Bank in Washington, D.C. and chairman of the D.C. Charter School Board, said that schools in D.C. make use of both structures.<sup>20</sup> Robbins and Simonsen (1996) state, “Private placements avoid many of the regulatory requirements of bonds sold through typical competitive or negotiated sale mechanisms, because they are designed to be sold directly to one (or to very few) investor(s) who hold them until they mature (or are redeemed). This creates potential opportunities for reducing the costs associated with issuance and disclosure that make such sales a potential advantage, particularly in cases where credit quality is poor or issue size is small.”<sup>21</sup> Nida agreed that the lower transaction costs of a private placement make that structure appealing to schools, although he estimates that fewer than ten financial institutions in D.C. offer that product. Similarly, Caldwell stated that the universe of bond buyers for negotiated sale bonds backed by charter schools is comprised of high-yield municipal bond funds, which total fewer than twenty firms as bond buyers. Charter school bonds are not yet an investment option for individual investors, according to Caldwell.<sup>22</sup>

Sophisticated management teams at some charter schools have also been able to obtain ratings for their publicly sold bonds. David Hitchcock, senior director at Standard and Poor’s (S&P), reported that its first rated, publicly sold bond deal involving charter schools was in 2001. By 2004, S&P had rated twenty-five bond deals for charter schools and seventy-nine bond transactions as of May 2008. Hitchcock reported that the median par value of the seventy-nine projects is \$11.3 million. (Hitchcock noted that although seventy-nine ratings are publicly available, S&P has conducted other ratings for bond issues. However, those ratings are not publicly released or the bonds are privately placed.) Additionally, Douglas Kilcommons, senior director at Fitch Ratings stated, “Bond issuance is absolutely increasing within the charter school sector, both in terms of the volume of transactions and the numbers of schools that have been able to receive investment grade paper.” Kilcommons credits the increase to more states becoming charter friendly; “Although there are more schools and the maturation of the industry correlates with an increase in sophistication in borrowing, the sector is still largely not well understood.”<sup>23</sup>

**Sample Transaction.** One sample negotiated sale tax-exempt bond issuance was \$17.9 million to finance a facility acquisition by Summit Academy, Inc., a Utah-based nonprofit organization that manages the Summit Academy charter school. The school was incorporated in Utah in 2003 and served 539 students at its opening for the 2004–5 academic year in grades K-6. For the 2007–8 school year, the school will serve 855 students in grades K-8.<sup>24</sup> As listed in the offering statement, the school’s income statements for fiscal years 2005 through 2007 are shown in Table 5.

*Table 5 – Summit Academy Income Statement Chart*

<b>Statement of Revenues and Expenditures</b>			
	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>Revenues and Support</b>			
Federal	\$ 692,442	\$ 390,398	\$ 188,312
State	2,011,550	2,125,301	2,620,733
Contributions	31,072	15,474	17,718
Interest	1,849	16,023	36,285
Other	5,000	10,000	38,651
<b>Total Revenues and Support</b>	<b>2,741,913</b>	<b>2,557,196</b>	<b>2,901,699</b>
<b>Expenses</b>			
<b>School</b>			
Salaries	900,015	949,015	1,062,777
Employee Benefits	251,434	313,892	270,186
Professional and Technical Services	24,143	37,248	60,676
Purchased Property Services	416,475	581,217	611,870
Other Purchased Services	16,996	1,557	95
Supplies and Materials	139,897	292,807	61,640
Property and Equipment	47,454	88,046	60,142
Other Expenses	13,193	9,226	11,030
<b>Supporting Services</b>			
Management and General	46,956	46,598	15,180
<b>Total Expenses</b>	<b>1,856,563</b>	<b>2,319,606</b>	<b>2,153,596</b>
Change in Net Assets	885,350	237,590	748,103
Net Assets at Beginning of Year	935	886,285	1,123,875
<b>Net Assets at End of Year</b>	<b>\$ 886,285</b>	<b>\$1,123,875</b>	<b>\$1,871,978</b>

Source: The Charter School’s audited financial statements for the fiscal years ended June 30, 2005-07

This bond issuance allowed the school to raise a remarkably large amount of debt to finance the acquisition of its existing facility. The school was also able to retire existing debt from an acquisition loan on a nearby piece of land where the school will construct a second building to serve junior high school students. As the Official Statement described, “Upon completion, the [combined] facilities will be located on a total of approximately 12.46 acres of land, include a total of approximately 93,987 square feet of school building space and are expected to accommodate 1,000 students in Kindergarten through grade nine.” The sources and uses for the bonds are shown in Table 6.

Table 6 – Summit Academy Sources and Uses

Sources of Funds:	
Par Amount of Series 2007A Bonds.....	\$17,795,000.00
Par Amount of Series 2007B Bonds (Federally Taxable).....	105,000.00
Charter School contribution.....	51,749.55
Original Issue Discount of the sale of certain of the Bonds.....	(87,216.40)
Total.....	<u>\$17,864,533.15</u>
Uses of Funds:	
Deposit to Project Fund.....	\$15,657,560.00
Deposit to Bond Reserve Fund.....	1,253,650.00
Deposit to Capitalized Interest Account.....	482,338.15
Costs of Issuance (including Underwriting Discount).....	470,985.00
Total.....	<u>\$17,864,533.15</u>

As listed in the statement, the bond issuance had \$17,795,000 in Series A tax-exempt charter school revenue bonds and \$105,000 in Series B taxable charter school revenue bonds. Of the Series A bonds, \$2.44 million will be retired in June 2017 and the interest rate on that debt was 5.125 percent, while \$15.36 million will be retired in June 2038 and its interest rate was 5.8 percent. The taxable portion of the bonds will be retired in June 2009 and bear interest at 7.5 percent. As the school builds out its new facility and expands its number of students, the debt service on the bonds is expected to be provided by net income from school operations; in addition, a significant debt service reserve has been built into the transaction. (Utah received grant funds from the Department of Education’s State Charter School Facilities Incentive Grants Program from 2004 through 2006.) The Standard and Poor’s rating on these bonds was BBB- (the minimum investment-grade rating).

#### ***Department of Education Credit Enhancement Program***

The Department of Education’s Credit Enhancement for Charter Schools program has been an effective tool for charters to improve their creditworthiness to investors. The organizations shown in Table 7 have been recipients of awards from the Department of Education program.

*Table 7 – Department Of Education Grantees List*

<b>Name of Awardee</b>	<b>Year of Award</b>	<b>Size of Award</b>	<b>Geographic Focus</b>
Building Hope	2002	\$5MM	National
California Charter Schools Association	2005	\$10MM	California
Charter Schools Development Corporation	2002; 2004; 2006	\$10MM; \$5MM; \$6.6MM	National
Civic Builders, Inc.	2008	\$8.3MM	New York, New Jersey
Community Loan Fund of New Jersey	2006	\$8.15MM	National
District of Columbia State Education Office	2004	\$5MM	DC
Housing Partnership Network	2007	\$15MM	National
Illinois Facilities Fund	2005; 2007	\$8MM; \$10MM	IL, IN, MO, WI
Indianapolis Local Improvement Bond Bank	2005	\$2MM	Indiana
KIPP Foundation	2006	\$6.8MM	National
Local Initiatives Support Corporation	2003; 2006	\$10MM; \$8.2MM	National
Low Income Investment Fund	2002; 2007	\$3MM; \$5MM	CA, NY, OR, NV, NJ, DE, DC
Massachusetts Development Finance Agency	2003	\$10MM	Massachusetts
Michigan Public Educational Facilities Authority	2007	\$6.5MM	Michigan
NCB Capital Impact	2002; 2003	\$10MM; \$8MM	DE, DC, GA, FL, MN, NJ, NY, PA, VA, WI
Raza Development Fund	2002; 2004; 2006	\$5MM; \$8MM; \$1.6MM	National
The Reinvestment Fund	2005	\$10MM	PA, NJ, DE, MD, DC
Self-Help	2003; 2006	\$8MM; \$2.2MM	National
Texas Public Finance Authority	2005	\$10MM	Texas

*United States Department of Education – www.ed.gov*

Jim Houser, who oversees the program at the Department of Education, stated that the review of grant applications is based on a numerical scoring system by grant readers external to the department.<sup>25</sup> The goal of the program is to leverage public dollars and provide incentives to private investors; grant funds can be used for guarantees for construction loans, leasehold improvement loans, and general facilities financing. Applicants are awarded extra points for their applications by serving communities with the greatest need for public school choice, which are typically those communities where the existing public schools are not performing well and large proportions of students come from low-income families.

The grant funds are usually drawn down in full in a one-time payment in advance of using them and may be invested, which, Houser noted, is unusual for a federal program.<sup>26</sup> The program is also unique in that the grant funds grow over time (through compounding interest) if the costs incurred, such as defaults on debt guaranteed through the grant, are less than the earnings on the investments. However, the program is subject to annual appropriations from the Department of Education, and total grant dollars diminished substantially between 2007 and 2008 (from \$36.5 million awarded in 2007 to \$8.3 million awarded in 2008).<sup>27</sup> Houser noted that the program grants are used by financial intermediaries, such as CDFIs, which are knowledgeable in trends in their local communities are aware of the needs of institutional investors.

### *Management and Finance Intermediaries*

A growing trend in charter school operations and finance is the use of third-party intermediary organizations to facilitate the management of a school's operations or the development, rehabilitation, or construction of its facilities. The use of third-party organizations, Charter Management Organizations (CMOs), for operations oversight and Development Intermediaries for development, rehabilitation, and construction for these purposes has improved the creditworthiness of schools. Lenders view a school's financial management as a key risk factor, according to Kende, but the use of a CMO for supervision of school operations can mitigate that risk.<sup>28</sup> Craig Henderson, president of the board of directors of the Chicago International Charter Schools (CICS), a network of schools in the Chicago metropolitan area (and one of four founding members of the organization), agreed that having high-performing CMOs oversee a school helps convince prospective bond buyers of the creditworthiness of a school or network of schools.<sup>29</sup>

Henderson notes that two factors aiding the performance of CMOs are: (1) the monitoring of CMOs by school management teams creates accountability for their performance; and (2) increased competition for expanding their own operations has created additional incentives for CMOs to excel in overseeing charter schools. Henderson, who is also the founder and president of a municipal bond money management firm, stated that CICS schools contract with third-party management organizations to improve operating efficiency, and from his experience, the use of charter management organizations at the twelve campuses of CICS has improved the network's creditworthiness with institutional investors.

David Umansky, co-founder and CEO of Civic Builders, Inc., a nonprofit organization based in New York that acts as a real estate developer for charter schools, stated his organization's general premise: "Charter schools should not be in the real estate business. Schools have financing and management challenges in dealing with real estate, which include managing, developing, and owning properties."<sup>30</sup> Acting as a development intermediary, Umansky says, Civic Builders encourages lenders to compete by improving the creditworthiness of a charter school project, often through new construction or renovating an existing building. Civic Builders has completed three projects in New York City and has four projects in process. The organization was awarded the only grant from the U.S. Department of Education's Credit Enhancement for Charter School Facilities program given in 2008; the geographic focus for the funds is New York and Newark, New Jersey.<sup>31</sup>

Another example of a third-party intermediary aiding schools in various capacities, including financial management, operations oversight, and real estate development advisor, is the Illinois Facilities Fund (IFF), based in Chicago. Jill Levine of IFF states that her organization "does anything and everything in schools' financing."<sup>32</sup> She adds that IFF has helped charter schools with a full continuum of loan and bond financing products and also is available to help schools with the identification of buildings, sites, and leases, as

well as serving as a project manager and owner's representative. IFF has used its grant funds from the Department of Education's Credit Enhancement Program for publicly sold bonds, and Levine said that bond investors have been encouraged by the strong relationship that charter school borrowers have built with IFF.

### ***State Intercept Mechanisms***

The state intercept mechanism is a practice that directs state or local agency per pupil funds directly to lenders (via trustees in bond deals) rather than paying the school first. In other words, with a state intercept mechanism, a state authorizing agency basically pays debt service, owed by schools, to lenders; the mechanism literally "intercepts" a school's operating or facilities revenues and places them in the hands of lenders (without involving the schools). The state intercept mechanism thus acts as a credit enhancement for lenders or bond buyers concerned about the risk of financial mismanagement at schools (such as schools paying other operating expenses before hard debt).

According to Douglas Kilcommons of Fitch Ratings, "The intercept mechanism helps ensure that the bondholder will receive timely principal and interest payments. This eliminates the risk that the school would use the bond proceeds for purposes other than paying principal and interest. State intercept mechanisms mean that bondholders get the 'first cut' of funds before the school does."<sup>33</sup> Nida of United Bank agreed that the state intercept mechanism, which has been put in place by Colorado and the District of Columbia, is a way to fix the issue of "cash flow risk."<sup>34</sup>

### ***Moral Obligation Pledge***

The moral obligation pledge provides the backing of the state or municipal finance authority in a charter school bond sale and has been a significant credit enhancement for charters borrowing funds through negotiated sale bonds. As of May 2008, only Colorado and Indiana had offered this pledge.

In Colorado, the Moral Obligation Program "enhances the credit of a . . . charter school that has obtained an investment grade rating on a 'stand alone' basis," according to the Colorado Department of the Treasury.<sup>35</sup> Under this program, charter schools that are able to obtain an investment-grade rating would have the balance sheet of the state of Colorado behind them in selling bonds to finance their facilities.

The Moral Obligation Program, part of the School Finance Act of 2002, exemplifies an opportunity for states to use their strong financial position and provide credit enhancement to charter schools.<sup>36</sup> As of June 30, 2007, bond transactions for twenty-four schools in Colorado had participated in this program, receiving the financial "backing" of their state; the total par value of those bonds was nearly \$300 million. Colorado funds its "debt reserve fund" for paying out principal and interest to bondholders in the event of default by a charter school by charging schools 10 basis points of the principal amount borrowed.

In Indiana, the legislature passed a law in 2002 to allow charter schools to obtain financing through the Indiana Bond Bank. According to the 2007 LISC Facilities Financing Report, "In addition to having access to these public authorities as conduit issuers, charter schools can benefit from the 'moral obligation' pledge of the City [of Indianapolis] or State [of Indiana], respectively, to debt issued through these authorities."<sup>37</sup> This form of credit enhancement is helpful in "telling the story" of charter school bonds in Indiana to institutional investor since the state's balance sheet is backing the bond sales. Additionally, the Department of Education awarded a \$2 million grant from the Credit Enhancement Program to the Indianapolis Local Public Improvement Bond Bank to aid with funding for the state's backing through its moral obligation pledge on charter school debt.

### **Underwriting Best Practices**

Underwriting charter schools has become increasingly sophisticated, as financiers aim to understand the metrics that drive efficient school management and enrollment increases. Underwriting charter schools "vary from state to state and even district to district," according to Mary Tingerthal. "New charter schools generally start with a ramp-up plan, making it tough to underwrite loans," she said.<sup>38</sup>

Before joining United Bank, Thomas Nida grew the charter school loan portfolio of City First Bank of D.C., a CDFI based in Washington, D.C.<sup>39</sup> While at City First, Nida created the Charter School General Performance Assessment (“GPA”) calculator, which has since become a standardized evaluation technique for analyzing finances and performance. As chairman of the D.C. Charter School Board, Nida has introduced the GPA calculator to staff members, and the tool has helped standardized the evaluation of schools’ performance and financial metrics. A sample worksheet from the GPA calculator tool is shown in Table 8.

Table 8 – GPA Calculator

Charter School Financial Report Card								
			Ratio	Score	Weight	GPA	Grade	
Balance Sheet	Current Assets	\$ 236,139	Current Ratio	0.50	0.50	1.3x	0.63	F
	Fixed Assets	\$ 46,598	Fixed Assets	0.16	4.00	1.0x	4.00	A
	Total Assets	\$ 282,737	Net Assets	(188,219.00)	0.00	1.5x	-	F-
	Current Liabilities	\$ 470,956	Debt to Worth	(2.50)	0.00	1.0x	-	F-
	Total Liabilities	\$ 470,956						
	Capital (Equity or Fund Balance)	\$ (188,219)						
Income Statement	Gross Revenue	\$ 1,020,298	Occupancy	0.142	3.00	1.0x	3.00	B
	Occupancy Cost	\$ 144,960	Payroll + Instruction	0.714	1.00	1.0x	1.00	D-
	Payroll Cost	\$ 644,688	Cash Flow	\$ (4,909)	2.00	1.0x	2.00	C-
	Instruction Cost	\$ 84,151	Profit Margin	-2%	2.50	1.3x	3.13	B
	Depreciation	\$ 13,469						
	Net Income	\$ (18,378)						
						<b>Financial GPA=</b>	<b>1.625</b>	
						<b>Implied Grade=</b>	<b>D</b>	

As Jeremy Williams, finance manager of the D.C. Charter School Board, described, the tool creates a financial score for charter schools on a 4-point scale. A high-performing school would receive an “A” or have a GPA that exceeds a score of 3.5; underwriting variables are weighed, with current assets and cash flows given added consideration.<sup>40</sup> Williams explained that a school’s “grade” according to the GPA calculator is based on its statement of financial position (the balance sheet for nonprofit organizations) and statement of activities (the income statement for nonprofit organizations). The D.C. Charter School Board’s goal is to modify the tool to integrate nonfinancial data such as number of teachers, staff turnover, student attendance, and whether schools own or lease their facilities. Nida adds that the tool is available to lenders and CDFIs upon request.

In evaluating the financial performance of schools relative to their peers, the D.C. Charter School Board’s summary metric is its GPA. From a school’s statement of financial position, the key ratios calculated for the purpose of formulating a GPA score are: current ratio, fixed-assets ratio, capitalization ratio, and debt-to-worth ratio. On a school’s statement of activities, the ratios considered are: occupancy expense ratio, payroll and instruction ratio, and “other” expense ratio. In terms of its operations, the D.C. Charter School Board indicates that a well-performing school has the following financial metrics:

- Personnel expense at or below 50 percent of total revenue
- Instruction expense at or below 10 percent of total revenue
- Occupancy (rent/mortgage) expense at or below 25 percent of total revenue
- “Other” expenses at or below 15 percent of total revenue
- Payroll + Occupancy at or below 75 percent of total revenue

The D.C. Charter School Board also evaluates the amount of cash flow that schools generate annually as well as their overall profit margin. Cash flow is calculated as a dollar amount and it includes annual depreciation and amortization expenses.

## Conclusion

The charter school industry in the United States has shown tremendous growth in the past fifteen years, with the number of schools, the number of states authorizing charter schools, and the number of students enrolled in charter schools all having increased substantially. The breadth of financial services available to charter schools has also expanded in this short time period. The public and private sectors have engineered new subsidy programs – at the federal, state, and local levels – and financing structures to encourage the flow of capital from lenders and investors to charter schools. As borrowers and recipients of funds via new structures, charter schools have used funds to support their day-to-day operations and acquire, expand, and develop their teaching facilities.

All of the interviewees for this paper were asked for their views of what the future holds for charter school finance. The overwhelming majority stated that bond activity for charter schools—the issuance of tax-exempt and 501(c)(3) bonds—for facilities would continue to grow. To date, approximately 10 percent of the country’s charter schools have been able to complete a bond transaction. Many interviewees estimated that this percentage would grow substantially, and might possibly double, within the next five years.

Interviewees agreed that the turmoil in the capital markets, which began in 2007, has put a strain on financing for charter schools. Investors have been wary of allotting resources toward “riskier” asset classes (and charters are still viewed by many capital markets investors as having a short track record), which has substantially increased the pricing for loans and bonds to finance charter schools.

Although the current credit crisis appears to be far from over, charter schools have been steadily building their cases for creditworthiness. Through solid enrollment growth, increased per pupil revenues for charter schools, and on-time and under-budget delivery of school facilities, a growing number of investors are learning about the ability of charter schools to borrow and repay debt on time and without complications. As the economy recovers from the tumultuous state of the capital markets, many of those interviewed expect that securitization of charter school loans will grow tremendously in the next five or ten years.

Lenders have become increasingly comfortable with charter schools as borrowers as a result of the presence of third-party intermediaries, particularly for the management of operations and facilities development. The number of these intermediaries is also expected to grow in the near future, as they play a valuable role in “telling the story” of charter schools’ creditworthiness to lenders. Additionally, charter schools have seen improved operating efficiencies from joining and developing through networks of schools (for example, the Chicago International Charter Schools network in Chicago). Those interviewed for this paper largely agree that the percentage of all schools belonging to networks will grow, and it is likely that schools will be permitted to “merge” with one another without having to revoke the charter of any merging schools. Approval of school mergers is expected to lower overhead costs for schools, which already operate on a lean budget.

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