

FUNDING OUR FUTURE: CHARTER SCHOOL FINANCE 101

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INTRODUCTION

A charter school is an independent public school established and operated under a charter for a fixed period of time.¹ Charter schools have the flexibility to operate free of many of the rules and regulations that govern traditional public schools' educational program, facilities and operations in exchange for increased accountability and scrutiny. They must be non-sectarian and must admit on a first-come, first-served basis or select from a lottery if demand exceeds capacity.

Minnesota was the first state to pass charter legislation in 1991, California followed in 1992. There are now 3,000 charter schools operating nationwide, serving approximately 690,000 students in 40 states plus Washington, D.C. and Puerto Rico (see box 1).²

Unlike district public schools, charter schools do not have direct taxing or bonding authority – two vehicles for financing traditional public school capital expenditures. While a handful of states have begun to create new programs to help charter schools finance capital and other start-up expenditures, 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.

¹ In California, charters are approved for up to five year terms. Some charters have been able to negotiate “evergreen” charters, whereby each year their authorizer approves them for a five-year term, so they have a rolling five-year charter. But, that is the exception rather than the rule.

² Center for Educational Reform, June 2004 (<http://www.edreform.com>).

LIIF'S INVOLVEMENT

Without sufficient public funding for quality facilities, charter schools face considerable uncertainty and instability as they often begin in temporary space not intended for educational purposes and must deal with the disruption of moves to new locations. One such example is a project in Inglewood that is converting a hospital to a school (see photos). With the growth in the charter school field -- including 155 new charter schools in California since 2000-- there is clearly a significant need for widely available, reliable capital to finance charter school facilities.

Because of its ability to aggregate capital, provide technical assistance, and creatively finance community facility projects, the Low Income Investment Fund (LIIF) is well equipped to add value to the charter school field to help solve the facilities challenge. As a national community development financial institution (CDFI), LIIF is a steward for capital invested in housing, child care, education, and other community-building initiatives including workforce development. LIIF currently has access to over \$200 million in capital for community development projects: \$100 million in on-balance sheet assets and the remaining \$100 million is in off-balance sheet capital for which LIIF is the sole administrator.

In 1999, LIIF formally incorporated education into its strategic plan, believing that education is a key component in economic mobility and asset growth for low-income households. Additionally, a number of LIIF's nonprofit community development borrowers want to serve a broad range of needs in their communities, recognize that the demand for quality alternatives to public education in certain neighborhoods is high, and seek community-based responses to those needs.



Name of project. Location. Size of hospital facility (i.e. how many beds). Years it has been shut down. Cost of project. Expected date of completion.

All of LIIF's charter school lending to date has supported schools that serve low-income and disadvantaged populations and/or poor communities. This charter school lending activity, inclusive of participation amounts from LIIF's lending partners, has consisted of nine loans approved to eight schools totaling \$12.6 million. LIIF's loans have ranged in size from \$100,000 to \$6.3 million, providing schools with a range of facility acquisition, construction, and renovation financing and supporting 1,957 quality charter school spaces.

LIIF's demonstrated expertise in capital market financing, knowledge of the charter school market, and successful underwriting of loans to community-based organizations resulted in LIIF's being awarded a grant of \$3 million in the first round of the U.S. Department of Education (DoE) Charter School's Facilities Financing Demonstration Program. This grant, one of five competitive grants made nationwide at the time, was made to help LIIF implement a lending program for charter schools in California. LIIF is using this grant as loan loss reserve funds to leverage \$64 million in private capital that LIIF and its partners are actively raising for further financing of charter school facilities. With a pipeline of over \$30 million in projects that will require financing in the next two years alone, LIIF is currently looking to tap new capital sources.

UNDERWRITING CHARTER SCHOOLS

LIIF has had no losses on its charter school portfolio, despite the perceived risks of lending to charter schools, which include a limited charter life, uncertainty over public funding, and newness of the market. LIIF has provided financing to both start-up and existing schools, schools that receive assistance from management companies, and those managed independently. As a result of the variety of these transactions, LIIF has first-hand knowledge of the complexity of underwriting charter school loans.

Below LIIF presents a summary guide to underwriting charter schools. While there are many other factors to consider than those presented, this discussion focuses on aspects of charter schools with which commercial real estate lenders may be unfamiliar.

Financial Analysis

LIIF reviews the systems, policies, and procedures that a school has developed to monitor, analyze, and manage its finances. It is important to ensure the quality of financial reports and financial management because of charter schools' reliance on public funding and accountability. Beginning with the '04-05 school year, recently passed California legislation requires charter schools to produce quarterly financial statements and annual audits.

The majority of charter school revenue is calculated based on average daily attendance (ADA) – not on enrollment. For example, if a school has enrolled 100 students, but only 90 percent ADA, the school will receive funding for 90 students. The vast majority of school revenue comes from public sources. All California charter schools automatically receive General Purpose Block Grant, Categorical Block Grant, and Lottery funding. Other programs are only available if the school enrolls low-income students (e.g., Federal Title I funding) or applies specifically for that funding (e.g., staff development money.) It is important to understand the timing, reliability, and conditions associated with each revenue source.

Because of the relatively low per-pupil funding for California charter schools, (as compared to public schools, which have access to capital funding, and other states' overall spending) many schools depend on some level of fundraising. Obviously, if a school is reliant on fundraising, it is important that they demonstrate a strong fundraising track record and pipeline. Schools may also need to attain certain milestones to draw down the funding and adhere to a set schedule by which the funding is released. Fortunately, California charter schools are also eligible to apply to the California Department of Education (CDE) for a grant of up to \$450,000 for planning and implementation costs, which is released over a three-year period. Finally, LIIF asks such schools to prepare a budget showing viability with only committed funds.

Personnel expenses are the single-largest category of expenses for charter schools, often representing 50 to 70 percent of the budget. And although charter schools have more flexibility over public schools since the union and wage scales that affect public schools do not usually apply, personnel budgets must be sufficient to attract talented teachers and administrators and to meet target teacher-student ratios. Other significant expenses include curriculum materials, books, computers, equipment, and supplies, which typically range from five to fifteen percent of a school's budget. In addition, charter schools often contract with outside companies to manage their financial and operational needs. These fees can range from five to twenty percent of the budget.

Facility costs will vary based on factors such as the nature of ownership or lease and the age, location and size of the facility. An ideal school facility provides 75-100 square feet per student; of this amount, about 50 percent should be allocated for classroom space. (However, many schools, whether by choice or limited budgets, make do with less space.) Occupancy

costs should not exceed 20 percent of revenue; a 2001 study of charter schools nationwide indicated an average of 12 percent.³

Finally, California state law requires districts to charge a one percent administrative fee for services provided to charter schools, and, if the district provides a facility for the school, they can charge up to three percent. It is important to ask whether and what level of operating reserve the school's charter requires. In addition, LIIF will typically also require a replacement reserve, in the range of \$0.50-\$1.50 per square foot.

Repayment Risk

Understanding the school's track record in attracting, retaining, and increasing its enrollment is critical in terms of assessing a school's ability to repay a loan. Many funders consider 300 to be a minimum enrollment for a school that is seeking to take on financing, although the type and need of the facility and financing will influence that level and LIIF has successfully financed schools with less than 150 students. LIIF monitors a school's waiting list and student attrition rate to ensure that the school remains on target to receive its budgeted revenue. (Approximately two-thirds of charter schools nationwide have waiting lists.)

Needless to say, charter schools can benefit from economies of scale with larger enrollments. However, many charter schools open by offering one grade of instruction and gradually increasing enrollment by adding one grade a year until they reach capacity. While this growth pattern has educational advantages and enables the school to build operational capacity slowly, it presents a challenge in structuring a long-term facility loan so that it can be repaid while the school is still increasing enrollment. (For this reason, many operators will lease temporary space for one-to-three years while they build up the financial resources and capacity to make larger facilities and financing more feasible.) When a school budgets for enrollment growth, not only will teacher costs increase, but the school will also have to allow for additional equipment, books, and supplies for the new children. After the school reaches capacity, costs in these areas, on an annual basis, should actually decline, with on-going replacement costs less than start-up costs.

LIIF also reviews the marketing plan for attracting new students and families. For example, where will the school advertise, how often, and what are possible feeder schools? It is also important to determine the break even enrollment and ADA, below which a school could no longer service its debt, and how likely it is that projections will fall to those levels.

³ Charter School Facilities: Report from a national survey of Charter Schools; Charter Friends National Network and Ksixteen LLC, April 2001 (<http://www.charterfriends.org/facilities-survey.pdf>).

In addition to strong demand and enrollment, accumulated reserves will also mitigate the repayment risk. However, only schools in their third year or beyond are likely to have much of a cushion built up (unless they have been unusually successful in raising private contributions). In the past, California has enacted legislation whereby schools in low-income communities are reimbursed at \$750 per ADA up to 75 percent of annual facility lease costs, which has enabled several schools to build up cash reserves. (This funding has been proposed for FY05, although its long-term prospects are uncertain.)

School Management

Because of the importance of strong management to oversee the complicated finances of charter schools and to attract and maintain the enrollment that drives loan repayment, LIIF places a strong emphasis on this area. LIIF analyzes the depth and breadth of management's experience, the recruitment plan for bringing on new staff, and the school's hiring and evaluation criteria. It is particularly important to get a sense of management's track record in operating programs of a similar size. While the experience of the founder is important, it is also critical to ensure that the school has an established management structure in place, with clearly identified roles and responsibilities and, ideally, a clear succession plan.

California requires that teachers of all "core classes" be certified. Schools then hire "classified" staff to teach non-core classes. Some amount of turnover is to be expected, particularly during a school's first few years. What is important is to ascertain the reasons behind the turnover (e.g., poor recruiting, lack of professional development, weak administration). Another discussion to have with the school surrounds the lessons learned from any turnover and the adjustments made to bring about a more stable environment.

In many cases, strong educators come together to form a school, and then seek to supplement their backgrounds by contracting with a variety of third-party management assistance providers for on-going school management. Services provided range from specific technical assistance with finance, curriculum, or real estate development to a comprehensive approach whereby a school's founding body contracts out the entire management and operations of the school to a third party.

There is a range of governance structures in charter schools. In California, some charter schools, referred to legally as "dependent" charter schools, are established or remain a legal arm of the school district or county office of education that granted their charter. Other charter schools, known legally as "independent" charter schools, function as independent legal

entities and are usually governed by or as public benefit ("not-for-profit") corporations. Still other charter schools form some sort of legal hybrid, or "in-between" structure, in which some governance powers remain with the district or county and others rest with the school governing body. The school's governance structure will be clearly described in the charter.

Another important aspect of a school's governance that LIIF reviews is the board of directors. Not only does LIIF look to see that a school has recruited members with a wealth and diversity of educational and professional experience (e.g., legal, finance, real estate, business or nonprofit management) but also members that represent the community. The relationship between the board, management and the community are also important considerations. For example, does the board have open meetings and are parents and the community involved in shaping the design of the school?

School Charter and Design

Since the charter is what allows the school to operate, it is important to carefully review the charter petition and approval documents from the school's authorizer. A charter school petition includes a description of the school's educational program, student policies and recruitment, human resources, governance and management structure, financial projections, and clarification of the roles and responsibilities of key parties. A school's charter in California is approved for five years (three years if initially approved by the State Board of Education, as noted below). The charter-granting agency has the responsibility to ensure that its charter schools are meeting the charter terms, are fiscally managed well, and are in compliance with all applicable laws. Charters in California can only be revoked or not reinstated for reasons of material non-performance.

Clearly, quality is an important factor, yet it is often hard to assess. LIIF analyzes a school as a business – how will management attract and retain its customers (children and families), what is its competitive advantage (i.e., what distinguishes it from other schools), and what is its mission? One place to go for some data on academic performance is to review the school's Academic Performance Index (API) score. California schools receive an API score annually. Recent legislation mandates that for a charter to be renewed, the school must pass one of four tests; one of which is achieving an API score of "4."

Since the school will be measured against its student achievement goals, it is important to assess how achievable the goals are: can the school's curriculum and program not only meet the needs of the surrounding community but also help improve student performance; has the

curriculum been used before; and what additional resources will be required, given the needs of the students or the special features of the school?

Political

Charter schools remain controversial politically. Many districts are reluctant to approve new charters, in part due to the monitoring required of them as authorizers. Thus, the relationship between the school and its district/authorizer must be carefully considered. In California, the vast majority of schools must first approach the district in which they will be located for a charter. If denied on that level, the school can apply to their county's Board of Education. If further denied, the school then has the option of applying to the state Board of Education. There is proposed legislation right now that would allow public colleges and universities to charter schools; however, the prospects of such legislation are uncertain.

LIIF also researches the district's prior and current relationship with charter schools – how many have they approved, rejected, or revoked? What level of monitoring does the district perform? What conditions must the school meet before it can open? LIIF also assesses the degree of community support for the school and involvement of community partners.

Collateral and Construction Completion Risk

In analyzing charter school loan requests, the emphasis noted above on cash flow, management, and the school's program becomes all the more significant given the difficulty of valuing charter school real estate collateral. The special purpose nature of school facilities, the lack of comparable facilities, and the urban locations --which are often undervalued-- of many schools complicate traditional loan to value analyses.

Schools that do not use state bond money for the acquisition or renovation of their facility or are not locating on school district property do not have to follow traditional public school construction procedures. Of course they must still follow local permitting requirements and code compliance. In LIIF's experience, charter schools often underestimate the time, costs, and skills required to undertake a facility development project. As such, LIIF strongly urges schools to contract with qualified project management personnel and with architects and general contractors that have experience with school projects. It is important to ensure that a school plans and budgets for a back-up facility, in case the renovation of its future home takes longer than expected, potentially delaying school opening in the fall.

Important characteristics of charter school locations include proximity to the students, access to transportation, safety, and age and size of facility. Lenders must be aware that the ability of

charter schools to offer a sizable equity contribution or additional collateral varies widely, resulting in the need to creatively structure charter school financings.

CONCLUSION

LIIF has long recognized the need for all CDFIs to broaden their sources of financing and is a leader in creatively identifying and structuring non-traditional sources of financing for all types of community development facilities, including charter schools. LIIF has had no capital losses on its charter school portfolio, and its 19-year loss rate on all lending is 0.16 percent.

LIIF is actively seeking to raise new capital for a charter school fund and is anxious to bring in financing partners that may be new to this field, whether through contributing capital to a charter school fund or working with LIIF on individual deals. This article was written to provide such partners with a background on underwriting charter school and bridge the information gap, so as to encourage them to participate with us. The need for facilities financing among charter schools is significant, will continue to increase in the coming years, and will require all of us to work creatively to solve the facilities challenge.