Low Income Investment Fund

Report to the Community

Charter School Financing: Challenges, Opportunities and Lessons Learned

Sixty percent of charter schools plan to expand their facilities in order to increase their schools' enrollment.[1]

Because charter schools have limited access to facilities financing, the Low Income Investment Fund (LIIF), a national Community Development Financial Institution (CDFI) based in Oakland, California, developed an innovative charter school facilities lending program. To enhance its work in this area, and support knowledge creation in the growing field of charter school lending, LIIF commissioned a study of selected charter school facility lenders nationwide. This survey, conducted in the spring of 2002, and updated in 2004, was designed to develop a better understanding of the landscape of the charter school financing market, and to build the collective knowledge base of organizations lending to charter schools.

LIIF surveyed six of the most active nonprofit and for-profit groups engaged in charter school facility financing across the country. Collectively, survey participants have made approximately 220 loans totaling nearly $200 million to charter schools. Participants were asked to discuss their experiences, challenges faced and lessons learned with respect to their charter school loan portfolios. Survey questions explored topics such as motivations for engaging in charter school lending, characteristics of the market, size and structure of loans, strategies for mitigating risk, challenges and success factors.

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While charter schools are a growing market for both CDFI and capital market lending, the field is still young. Very little information has been disseminated among lenders about best practices. It is hoped that this survey will increase this shared knowledge, as well as catalyze the growth of new charter school facility funders across the country.

Background

Growth of the Charter School Industry

The charter school movement grew out of a history of educational innovations, such as alternative schools, magnet schools, public school choice and school privatization. According to the US Department of Education's US Charter Schools Web site:

> "The term 'charter' may have originated in the 1970s when New England educator Ray Budde suggested that small groups of teachers be given contracts or 'charters' by their local school boards to explore new approaches. Albert Shanker, former president of the AFT, then publicized the idea, suggesting that local boards could charter an entire school with union and teacher approval. In the late 1980s Philadelphia started a number of schools-within-schools and called them 'charters.' Some of them were schools of choice. The idea was further refined in Minnesota and based on three basic values: opportunity, choice and responsibility for results."

The charter school movement is growing at a remarkably rapid pace. The first charter school law was passed in Minnesota in 1991, followed by California in 1992. By 1995, 19 states had signed charter school laws, and by 2004 that number had increased to 41 states, Puerto Rico and the District of Columbia.[2] There are currently approximately 3,000 charter schools serving 800,000 students across the country.[3] Charter schools are becoming increasingly prevalent in low income communities in response to the overcrowded, neglected and underperforming schools that are often characteristic of these communities, all of which inhibit a productive learning environment.

Facility Challenges

In spite of this rapid pace of growth, the vast majority of charter schools lack adequate facilities. Locating and financing a suitable school facility is one of the greatest challenges facing charter school developers, and can often delay the approval and start-up process for months or even years. Particularly in urban areas, facilities are extremely scarce, and school founders typically lack the capital and real estate development expertise required to lease or purchase a site. According to a study conducted in 2001 by The Charter Friends National Network and Ksixteen LLC, the average annual lease and/or loan payment for facilities is $192,000. This cost amounts to 12 percent of the average school's overall budget. Some schools (3 in 10) spend 15 percent or more of their funds on facilities.[4]

Opportunities

Who Is Lending to Charter Schools?

While most charter schools have historically relied on traditional banks, landlords, bond proceeds, donations and/or state funds to finance the cost of facilities, these funds are characterized by restrictive terms, high rates and limited availability.

Given the financing challenges charter school developers face, many schools are beginning to seek loans from less traditional sources, such as CDFIs and other community development lenders. Many CDFIs and community development lenders that lend to charter schools view a strong education system as a critical anti-poverty tool. In turn, these lenders offer products and services that are responsive to the needs and financial constraints of charter schools in their lending areas. Further, these groups are often able to offer loans that can accept a higher risk level and/or unusual terms unattractive to commercial financers.

All survey participants represent financial institutions with some degree of explicit focus on community development and with a significant track record of lending to charter schools. Three survey participants are CDFIs, one is the social investing office of a large

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insurance company, one is a local bank and one is the development arm of a national bank. Four participants are nonprofit organizations and two are for-profit organizations. These participants were selected for their high volume of financing for charter schools and the diversity of their experiences.

Only one survey participant had a national focus for its charter school lending program. As such, many states, including those with a large number of charter school students, can get overlooked due to a lack of investors in their region. For example, participants have been less active in three states with a large number of charter schools (Texas, Arizona and Florida). Because of the regional focus of most survey participants, their borrowers tend to be concentrated in the Midwest, East Coast and Southeast, with the largest loan disbursements in Michigan, New Jersey, North Carolina, Pennsylvania and Washington, DC.

Survey participants stated that community development is their primary motivation for charter school lending. When asked to elaborate on this, participants said:

> "We feel that strong public schools are a cornerstone of any solid community. Good schools keep families involved in neighborhoods, and this involvement is an essential element of community revitalization."
>
> "[We lend] to charter schools to provide a public education alternative in targeted areas with high poverty and low-performing school districts. It is an investment in the region's human capital."
>
> "Charter schools can catalyze community economic development in low income neighborhoods."

What Is a Typical Charter School Facility Loan?

The charter school lending experience of these six organizations can be characterized in the following ways:

- The average loan size is approximately $880,000.
- Most of the loans (over 50 percent) are greater than $600,000 and increasing in size.
- The most common use of funds (approximately 50 percent) is for predevelopment, acquisition or construction.
- Leasehold improvement loans account for approximately 20 percent of survey participants' charter school loans.
- The remaining loans are for working capital or other purposes.
- The vast majority of charter school loans are concentrated in low income areas, reflecting the motivations of the community lenders surveyed.

Overall loan performance is very strong. Nearly all of the participants reported that they have had no write-offs.

How Are Charter School Loans Structured?

Most participants reported a loan-to-value ratio starting at 75 percent, moving towards a high of 100 percent on real estate, and a debt service coverage ratio of 1.1–1.25. Cash flow from school operations is the primary source of loan repayment.

Five of the six participants stated that they have or would be willing to accept a subordinate position to other lenders. However, the decision to subordinate is heavily contingent upon the identity of the other lender.

Survey participants vary widely in their use of guarantees. They are required by most when the loan-to-value ratio is high (and when financing leasehold improvements), and lenders have used a wide variety of sources for those guarantees.

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Regarding guarantees, lenders said:

> "Guarantees are sought when the partner organization can offer a needed credit enhancement to the borrower. In some cases, where the real estate holding entity is the borrower, guarantees or a security agreement with the charter school is required."

> "We have used third party collateral on some loans, such as a second lien on a founder's home, or stock from an individual. Guarantees are ... more common than collateral. We always get government guarantees when they are available."

How Have Charter School Loans Performed?

Only one participant reported a significant number of loans requiring material restructuring. Three lenders reported no loans requiring material restructuring.

Participants reported, however, that the vast majority of borrowers require a significant amount of technical assistance from the lender or an outside service provider. Most technical assistance takes place as part of the underwriting process, and is focused on financial planning. Participants universally considered technical assistance to be a critical success factor, although most said that they do not have the resources to provide in-depth support themselves. Regarding technical assistance, participants said:

> "[We do not] provide formal technical assistance to charter schools. However, throughout the underwriting process, we work with applicants to improve the quality and clarity of their financials, budgets and projections."

> "Our objective is to provide a viable financial framework for the school. We provide assistance in areas such as board development and charter authorization. We also help borrowers access accountants, real estate appraisers and lawyers."

Who Are Charter School Borrowers?

Charter schools are operated by a variety of organizations. They include stand-alone schools, both for-profit and nonprofit Education Management Organization (EMO)-managed schools, nonprofit Charter Management Organizations (CMOs), and schools that are affiliated with a local nonprofit group, such as a community development corporation or a youth development organization. Approximately two-thirds of the financing provided by the groups surveyed was provided to a school affiliated with an EMO, CMO or a local non-profit group.

Borrowers also vary significantly in terms of the stage of their organization's development, strength of management and level of expertise. All survey participants have financed schools in their start-up stage, and some work almost exclusively with start-up schools. However, given the additional risks involved with a start-up venture, other participants prefer to focus on more mature schools. In all cases, though, the school leaders often lack strong project planning and financial skills.

Key Lessons Learned

Solid Management Experience Is Critical to a Successful Deal.

All of the lenders participating in the survey stressed the importance of a strong management team in ensuring the success of a charter school transaction. Particularly when working with start-up schools, lenders said they pay special attention to the depth and breadth of the management team, as well as the involvement of a nonprofit affiliate or partner such as an EMO, community development corporation or technical assistance provider.

They look carefully at management quality and stability, especially the make-up of the board, when assessing the viability of a deal. The capacity of the management team is an important factor not only in the successful completion of a deal, but also in the ongoing operation of the school. This view is extended by some survey participants to include consideration of the value added by EMOs, CMOs and other (usually local) community sponsors of a charter school.

Given the importance of a charter school's management team, a future study should focus explicitly on assessing the value added by the participation by an EMO or sponsoring agency.

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Of note, however, the one participant that has made loans to a significant number of EMO-managed schools is planning to strengthen its collaboration with selected EMOs. Nevertheless, challenges arise in the relationship between an EMO and the local school with which it is working.

> "The EMO may have the expertise, but the school's Board of Directors has the final decision. As lenders we need to know that our borrower, even as part of an EMO, has the ability to make independent decisions."

Without guidance from an EMO or other sponsoring agency, borrowers often need to rely almost exclusively on their own internal expertise due to a lack of high quality technical assistance providers or involvement by the authorizing agency. Survey participants expressed frustrations with the hands-off approach of most charter authorizers.

> "The charter school authorizers are not always actively involved. They tend to be more passive due to either lack of resources or expertise."

As a result, lenders place a great deal of emphasis on "the importance of solid management with clear controls and decision-making processes." Further, several participants emphasized that a strong sponsor, often a community group, was key in facilitating the control and processes for a number of their charter school borrowers.

Board leadership is essential to the overall strength of the management team. Lenders pay close attention to who is on the board, the level of commitment of board members, and the depth and breadth of experience they bring. According to one survey participant,

> "It is important to look carefully at all facets of the leadership team. Make sure the board is a 'true' board with a broad range of skills and experience."

Some lenders work closely with the school to help develop the board by identifying key needs and recruiting individual board members with the requisite expertise.

Technical Assistance Is an Essential Part of the Deal-Making Process and Beyond.

While technical assistance is rarely a formal requirement, lenders suggest that it is a critical part of the deal-making process. As mentioned earlier, most survey participants reported that they work closely with their borrowers to

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package a deal, and some also play a significant part in other aspects of the school's development, such as project planning, board development or real estate management. However, they also noted that most technical assistance was provided at an early stage as an integral part of underwriting the loan, and was of a limited nature after the loan was made. Further, most participants said that it is often difficult for schools to find high-quality technical assistance on real estate financing and development.

The bulk of the technical assistance provided by lenders revolves around the process of putting the deal together. In the earliest stage, there is a need to manage the expectations of the borrower as far as timing is concerned. They often need to be educated about the process and timeframe for getting the loan packaged and approved. Many first-time borrowers are unaware of the lead time required, and approach the CDFI much too late in the process.

Many loan officers spend a great deal of time working with the borrower at the outset to frame the deal, and provide financial planning and project planning help. Most borrowers lack financial acumen–often they have never had experience with budgeting or projections. A "heavy dose of reality" is often needed to get the deal done. Of this need for assistance, participants said:

> "Just getting to the closing requires lots of assistance, [especially in the areas of] financial management, legal issues, leasehold improvements and bridge financing."

> "Most of our assistance occurs as part of the underwriting process. We provide some assistance in the area of real estate development, specifically through a resource guide we published and offer for free. Borrowers can sometimes turn to expertise offered *pro bono* via a charter school resource center or other nonprofit or government agency. There are some private technical assistance organizations that charter schools can hire. Technical assistance is not a requirement, though we do encourage it."

Several survey participants also talked about accessing architects or other professionals with relevant expertise, such as accountants and lawyers, to provide guidance to charter schools. Technical assistance providers who specialize in working with charter schools also provide help in areas such as curriculum design and teacher recruitment.

Some lenders play an ongoing role in guiding the decision-making and operations of the school. One participant has sat on the board of a school and helps recruit board members with specialized expertise, especially in finance.

Charter School Lending Is Yielding Promising Social and Financial Returns.

While it is too early to assess the long-term financial results of charter school lending, most lenders are pleased with the early indicators of financial performance they are seeing within their charter school portfolios. As stated earlier, only one lender participating in the survey has experienced a loan write-off. They feel that lending to charter schools is proving to make good economic sense, as well as representing a high-impact tool for stimulating community development in low income areas.

The Development of Performance Benchmarks Would Facilitate Access to Capital.

While charter school lending experience has so far been positive, growth of the field, as well as optimal pricing of loan products, will be advanced by the development of school performance benchmarks. As one survey participant noted:

> "Absent such benchmarks, schools will be limited in their access to capital, and may be subject to more stringent terms and pricing for credit that may be obtained, reflecting a higher risk assessment than is really justified ... lenders ... charter school operators, authorizers, supporting organizations and even EMOs and CMOs would benefit from development of commonly accepted performance standards that go beyond results of standardized test scores and adequate cash flows to facilitate creation of potential secondary markets for loans and bonds."

Such benchmarks might include:

- Enrollment as a percent of capacity;
- Enrollment trends and waiting lists;
- Salaries, debt service and fundraising as a percent of revenues;
- Degree of parental involvement; and
- Academic performance and progress on other standards in the charter.

These sample benchmarks could be especially useful if developed and used alongside Moody's Rating Methodology, issued in July 2003. In reporting on its total of $297 million in rated debt for charter schools, and its opinion on the future of the field, Moody's listed five key factors it used in assessing the quality of charter school debt issuances:

- Service area demographics and enrollment trends;
- Management, policies and fiscal goals;
- Security features, including additional bonds test and flow of funds;
- Oversight issues; and
- Charter renewal risk.

The Future of Charter School Lending

As the charter school industry further matures, future studies should continue to track lenders' experiences, probe deeper into the needs of charter schools for facilities finance, better document the performance of a larger and more mature market, and test the findings of this report.

Participants are currently exploring the following new initiatives:

- Working with charter school authorizers to increase their level of involvement and focus on accountability;
- Working to build the capacity of charter schools so that they are less dependent on EMOs;
- Increasing the dollar size of transactions;
- Playing a role in the bond market in collaboration with larger banks;
- Bundling services to charter school staff and parents (e.g., consumer education, direct deposit payroll, retirement plans); and
- Expanding the geographic scope of charter school lending.

Several participants are also engaged in policy issues relative to facilities for charter schools. One reported that "I've always envisioned a future which has charter schools gaining access to the tax exempt bond market under terms and conditions comparable to public schools. I see [us] and other CDFIs playing a developmental role that eventually has us working our way out of a job."

Another development in charter school financing was the establishment of the US Department of Education's Charter Schools Facilities Financing Demonstration Program (subsequently replaced by the Credit Enhancement for Charter School Facilities Grant Program). In June 2002, the program awarded the first five in a series of grants intended to demonstrate different approaches to assisting charter schools in obtaining appropriate financing for their facilities. Coincidently, three participants in this survey are recipients of these awards.

Conclusion

The most remarkable finding of this survey is the very low level of loan write-offs for charter school loans. It is important to note, however, that lending to charter schools remains a fairly young activity, and the rate of write-offs may increase. Further, participants have made loans to a small portion of charter schools now in operation. Nevertheless, with approximately 220 loans totaling nearly $200 million, and many loans made to start-up schools, this loan performance experience is quite striking.

Are the special risks that charter schools appear to present to lenders more perception than fact? It will be important to watch this situation closely over the next several years. If loan performance maintains this track record, it may well provide the basis for significant expansion of charter schools' ability to tap commercial capital markets. In fact, one participant reported losing several loan prospects to commercial financial institutions offering lower-priced products to the borrower, and is expecting the market to continue to become more competitive.

Lending to charter schools is proving to make good economic sense and is a high-impact tool for stimulating community development in low-income areas.

Perhaps the high degree of technical assistance reported by survey participants is a key factor behind the good performance of charter school loan portfolios. This conclusion seems likely given that survey participants made loans to a significant number of start-up schools and to "stand alone" schools, and that most charter school management teams do not have significant financial skills or borrowing experience. While the survey did not assess the costs of this technical assistance, and therefore cannot compare it to other types of CDFI lending, it is quite possible that those costs exceed what a purely commercial lender would be willing to incur.

As for much other CDFI lending, it may well be that the need for CDFI involvement in charter school financing is driven not so much by the risk of high loan-loss rates as it is by high transaction costs. If true, this would indicate the likelihood of a strong role for CDFIs in the charter school sector for the foreseeable future.

Charter schools are an important innovation in public education and present a growing opportunity for CDFIs and other community development lenders. Lending experience will deepen considerably over the next several years, including that gained through the US Department of Education's Credit Enhancement for Charter School Facilities Grant Program, and should be tracked closely so that all may benefit from lessons learned.

The results described in this report provide important illustrations of the charter school lending market, which will need to be closely tracked as the field matures.

1. Charter School Facilities: Report from a national survey of Charter Schools, Charter Friends National Network and Ksixteen LLC, April 2001
2. US Charter Schools Web site: www.uscharterschools.org
3. Center for Education Reform
4. Charter Schools, Charter Friends National Network and Ksixteen LLC, April 2001

In this paper, the term "CDFI" is used to describe lenders with significant community development focus, whether or not they actually have been (or could be) certified as CDFIs.

Survey Participants

Center for Community Self Help
City *First* Bank of Washington, DC
Low Income Investment Fund
NCB Development Corporation
Prudential Foundation
The Reinvestment Fund

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