

Assessing Charter School Credit: What Do Investors Seek?

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"What are the criteria that make a charter school eligible for a tax-exempt bond financing?" This is a frequent question I receive as I meet with charter school leaders throughout the country who desire to own their facilities.

There are several metrics, both quantitative and qualitative, that institutional bond investors are looking for when they make a decision to allocate their capital to a certain charter school project. The very first thing investors want to hear about is the academic performance. Clearly, the reason schools are granted a charter in the first place, to educate students. So investors are wary of investing in a school when academic performance is not up to par, as they know this is one of the main reasons a school can lose its charter. There are some situations when charter schools are educating students in a low socioeconomic area with students facing many unique life challenges. These students may not have the resources at home that contribute to academic success in the classroom. Investors understand these situations and many are drawn to investments where lower socioeconomic students are being educated. In these scenarios, investors compare the school's academic performance to the schools the students would attend if they didn't have the opportunity for school choice. If the charter school's academic performance is stronger than the competing district schools, or similar charter schools in the area, then clearly they are providing a benefit to the families in the community, would be viewed as positive by many investors as well as the authorizer.

Along with the academic performance data investors also require the type of education or niche curriculum being offered to students. Investors will ask the question, "Why would a parent choose your school?" Sometimes the answer is the traditional schools are overcrowded or not meeting the state academic standards, but there are other situations in which parents are looking for a specific pedagogy that integrates the arts, STEM, international baccalaureate, or project-based learning, for example. This is where every charter is unique and has its own story to tell.

The ability to show demand for your program is also an important part of the credit story. It is very important to accurately document demand by maintaining a student waiting list by grade. Investors need to feel confident if there is attrition during the school year – there is a student waiting to fill the seat. Your waitlist should be scrubbed yearly and only include the students truly interested in attending if an admitted spot opens. The most efficient way to monitor this is to require the parents to fill out a new application each year if they want to remain on the waitlist. I have been told some charter school leaders do not maintain a waitlist because they do not want to promote false hope to parents who are desperate to get their children into a better school. This is understandable, but the only way investors can measure the parental demand of the program is through quantifiable proof.

Along with the importance of the waiting list is the ability to show steady enrollment gains or, if the school is at capacity, stable enrollment during the last few years. If there are big swings in enrollment from year to year, this will be a concern to investors. Student retention is one of the quantitative metrics investors will want to see. This also applies to the staff and teachers. If teacher turnover is high, they will want to know why. Sometimes there is a very good reason, such as using Teach for America teachers where they are younger and may be required to move from one school to another frequently.

When it comes to management and governance, you should have a deep bench of talent to pull from. If you are an administrator, there should be a contingency plan in place. If for some reason you are unable to lead the school, what will happen? Will things continue to operate smoothly with the team you have assembled? Investors are making a 30-year capital commitment when they invest in charter school bonds, so they expect administrators to take both a short-term and long-term perspective to planning. When opening you should assemble a strong board with a diversified skill set. Having a board of educators is understandable because

you want to get the curriculum right and establish a solid education foundation. However, you also need to have someone on the board who understands how a business should be run. If you are assembling a board or adding new board members, you should consider someone who understands financial statements since part of the board's responsibility is financial oversight. Other professional backgrounds that can help the school succeed include legal, real estate and construction. The latter are especially helpful if you are contemplating construction of a new school facility.

So far, most of what I have shared involves qualitative metrics investors will consider in their analysis, but of course, financial metrics are equally important. If you have posted operating surpluses each year since inception you have clearly done a great job of living within your means and managing expenses. This will be extremely helpful when accessing the public market to raise capital for your school project. Unfortunately, there are situations when this may not be possible due to state holdbacks or per-pupil funding cuts. The investors BB&T has relationships with are on top of what is happening in each state and within the sector and sometimes there is a very explainable reason for an operating loss.

Bond investors love the age-old saying "Cash is King." When schools have plenty of cash in the bank, investors feel more confident they will receive their principal and interest payments as scheduled. A healthy goal is for schools to have at least 45 days of cash on hand, the industry standard. It can be quite a challenge to manage payroll and the other monthly expenses without at least one and a half months of cash in the bank. We have worked with schools with less than this when they issued their debt, but the liquidity covenant usually requires the school to ramp up by a certain number of days each year until they reach 45 days.

This article would not be complete without touching on leverage. Schools must be careful about taking on too much debt as this is fixed overhead that will not change for several years unless you have the ability to refinance. The rule of thumb is to keep debt service below 20 percent of revenues. For schools ramping up enrollment, this metric will improve as your enrollment stabilizes. The optimal number is between 10 and 15 percent, which allows more of the budget to be allocated to the educational needs of the students and in the classroom where it belongs. Another rule-of-thumb metric is debt per student. This can fluctuate from state to state, especially in areas where real estate is more expensive, but the number that investors like to see is around \$15,000 per student when enrollment is stabilized. The amount of state funding or additional federal funding will be a consideration since each state and situation is different, but that is a good way to calculate what you can afford.

Every situation is unique and every school has its own credit story. This is the reason charter school leaders should consider hiring an investment banker who understands the ever-changing nuances of the charter school sector. We understand charter schools do not have the luxury of increasing taxes when they need more revenue and must operate within the revenues allocated by their respective states. The charter school bankers at BB&T are deliberate in their decision to work with charter schools. We understand there are going to be obstacles to overcome in every transaction. We will help you tell your story – highlighting your strengths and explaining any challenges that have come your way – to get your facility project funded in the capital markets, so you can focus on educating your students.

To discuss this information further or if we can assist you in any way, please visit BBTCapitalMarkets.com/Education to access contact information. Any member of our team would be happy to speak with you.



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