BB&T Capital Markets

What are the characteristics that make a charter school suitable for a tax-exempt bond financing?

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While a frequently asked question by charter school leaders and their advisors who desire to own their facilities, it is important to note that no single metric is determinative. The purpose of this article is to provide broad insight as to the high level credit characteristics that bond investors will be assessing. There are numerous metrics, both quantitative and qualitative, that institutional bond investors are looking for when making a decision to allocate capital to a certain charter school project.

Diverse board and management team

Most investors begin by analyzing the strength and composition of the board and management team of a school. While boards and management hold close ties to one another, their duties and responsibilities are distinctly different. In a general sense, the board makes the decisions and management carries them out. It is important to note that investors and key stakeholders will want to understand the policies and procedures instituted to ensure that the board is informed. The board of directors should be a diverse group of professionals; in a collective sense, the board should understand how a business is effectively operated and maintained. The board should represent the diversity of the community it serves.
The complexity of today's business world requires varied professional backgrounds and experience, including an individual who can read and understand financial statements in order to oversee the school's financial responsibilities. Other professional backgrounds including, but not limited to, legal, human resources, education, real estate and construction also play a critical role in the school's success. Careers in real estate and construction are also valuable additions to the board, and are especially beneficial if the school is contemplating construction of a new facility in the coming years. Boards should focus on the long-term vision, and forecast how the school will appear up to five years in the future. Boards should curb their participation to quality, growth, finances, and staff. Future goals should be measured by initiatives and key quantitative and qualitative metrics. Lastly, it is important to consider the length of each term, succession planning and a clear conflict of interest policy when assembling or maintaining the board of directors.

The role of management is to keep with the board's direction: operational decisions and policies, communication protocols with the board, and strategic recommendations in keeping with the mission, long term direction and academic advancement of the school. As the school expands into new grade levels (i.e.; high school), investors will examine the experience of the management team with such an expansion. The management team should have a deep and broadly knowledgeable bench of talent to carry out long term vision and mission of the board, most notably with financial matters. Retention of leadership and staff is a key metric utilized by investors when assessing a school's ability to operate in the complex, evolving, and often politically challenging environment of education. Last, as with the board, a clearly articulated succession plan must be in place for key leadership positions, as investors are making a long-term, 30-35 year commitment of capital.

Academic performance

Academic performance is the single greatest qualitative predictor of long term, systemic success. Given that schools will likely lose their charters given systemic poor academic performance, investors are unlikely to invest in a school when academic performance is not up to par. 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 to support their academic success in the classroom. Investors understand these circumstances and often seek investments where lower socioeconomic students are the focus of the mission and the unique circumstances are being successfully addressed and served. In these scenarios, investors compare the school's academic performance to the schools the students would otherwise attend if they didn't have the opportunity for school choice. Investors will look at year to year improvement as well as the intra-year advancement of students. 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. This may be viewed as positive by many investors as well as the authorizer. In addition to the academic performance data, investors also consider the nature of education or niche curriculum being offered to students: arts infused, STEM, classical, international baccalaureate or language emersion.

Showing demand builds investor confidence

The ability to demonstrate demand for your school and mission is essential to providers of long-term capital. The most effective way to accurately document demand is to maintain a student wait list by grade, unless the school is one of the few charter schools that selects students based on testing instead of lottery. Given attrition during the school year, investors need to feel confident in the process of waitlisted students matriculating into a classroom seat. The waitlist should be updated annually to only include the students truly interested in attending if a vacancy occurs. The most efficient way to monitor this is to require parents to complete a new application each year in order to remain on the waitlist.

In addition to implementing waitlist procedures, demand analysis or market feasibility can build investor confidence by showing the ability to stabilize enrollment or to support sound and uniform enrollment gains during periods of expansions. Unexplained, broad swings in enrollment from year to year is considered a "red flag" and is a major concern to investors as student retention is one of the key quantitative metrics investors will examine. As noted and worth repeating, this also applies to school staff because high teacher turnover is a leading indicator of a broader crisis. However, schools may highlight strategic and reasonable explanations, such as utilizing Teach for America or visiting language instructors.

Other qualitative Measures and framework, budgeting and cash flow

Other qualitative metrics and analyses include an understanding of state regulations and the political climate, authorizer relationships, market saturation and local competition. While the qualitative analysis serves to provide a broad and unique background and framework charter schools must operate within, a careful analysis of the operating performance and financial condition of the school will serve as the backbone of an investor's interest to provide capital. All borrowers must show a reasonably sound ability to pay back its debt, as demonstrated by a sound track record of meeting or exceeding annual budgets. For example, posting consistent operating surpluses each year demonstrates management's aptitude to operate within budgets and management of expenses. This will be extremely helpful when accessing the public market to raise capital for your school project. It is critical to recognize there are legitimate reasons for a non-reoccurring operating loss such as a state holdback, per pupil funding cuts, or other one-time expenditures. What is imperative is to demonstrate management's ability to meet or exceed, on an ongoing basis, the school's annual budgets and/or long-term financial forecasts.

Cash is king

Liquidity, or cash and liquid investments, is a key quantitative metric for bond investors. When schools have plenty of cash in the bank, investors feel more confident they will receive their principal and interest payments as scheduled. This liquidity position also serves as a cushion given unexplained interruptions in revenue. A healthy goal is for schools to have at least 45 days of cash on hand, the industry's minimal 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. If schools have less than 45 days of cash on-hand, most notably during a period of growth and "enrollment ramp", the school must clearly demonstrate the ability by budgeting procedures to build cash reserves during the period to achieve stabilization, until they reach or exceed 45 days.

Manage debt

This article would not be complete without touching on leverage. Schools must be cautious about taking on too much debt, as it is fixed overhead cost that will not change for several years unless there's an opportunity to refinance. The rule of thumb is to keep debt service below 20 percent of revenue. For schools ramping up enrollment, this metric will improve as enrollment stabilizes. The optimal number is between 10 and 15 percent, which allows more resources to be allocated to the educational needs of the students and in the classroom. Another important metric is debt per student. This can fluctuate from state to state, especially in areas where real estate is more expensive. A reasonable number that investors look for is approximately $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 context is different.

Summary

Every charter school has a unique set of circumstances, and there are many reasons why schools should consider hiring an investment banker who understands the ever-changing nuances of the charter school sector. The BB&T Capital Markets education team understands that charter schools do not have the luxury of increasing revenues and must operate within the funding allocation by their respective states. Our team seeks to anticipate many of the obstacles that charter schools face as we tailor financing solutions to overcome them. Working closely with your board, management and advisory team, we can help you tell your story to investors and get the funding you need to support your incredibly worthwhile mission of educating students.

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