Charter School Bonds: An Introduction
Introduction

Over the past twelve years, the high yield tax-exempt bond market has seen significant growth of bonds issued by charter schools. This growth is fueled by a national outcry for K-12 education reform. Facilities financing is likely to increase further as these charter schools gain greater public acceptance and bi-partisan political support. As early investors in this sector, Hamlin Capital has participated in over sixty transactions and now represents over six percent capital share of this universe. Here we share with you a general overview with a brief history of public charter school bond financings. We will also provide you with Hamlin’s key criteria on navigating this investment theme including how we manage the many challenges charter schools confront.

Background

For the kind reader who may not be familiar with the emergence of the charter school movement in the U.S., we will provide some background. Charter schools are public schools serving grades kindergarten through high school that are operated independently from their local school districts. In exchange for its operational independence, the schools’ accountabilities are to educational achievement goals set forth in their charters. In the U.S., 42 states have passed legislation permitting charter schools. States and their local jurisdictions vary in terms of charter authorization criteria, governance and financial support. There is no national charter school mandate, as education is a state and local matter.

This grass roots movement started in the early 1990’s mostly in Arizona, Colorado, Michigan and Minnesota with very humble beginnings. Most schools were small with less than 200 students led by impassioned educators or parents seeking alternatives to their local district schools. Charter schools in most cases do not receive space in public facilities nor a separate funding line item for facilities. Securing facilities space is among the top challenges facing charter schools. In their early years, they leased space from unconventional landlords. Many were in basements of local churches, modular housing units, or in vacated retail spaces of strip shopping malls. Academic and financial management were major challenges for these nascent schools. Some failed as a result. As time rolled on, the ones that thrived gained acceptance from their local communities as well as banking and investment institutions to finance their facility needs. In 1998, the first charter school tax-exempt bond issue came into existence.

Hamlin Capital was introduced to the Grand Traverse Academy in 2002. This was our first foray into this promising socially responsible investment opportunity. The Michigan public charter school wished to borrow $9 million through tax-exempt bonds to finance the land purchase and construction of their permanent school facility. The financing met Hamlin’s investment theme— an essential service provider in a growing market, the pledge of gross revenues to bondholders, bonds secured by a first mortgage on plant, property and equipment, acceptable credit metrics and an attractive return/risk profile. Providing quality education to their community was icing on the cake. The Grand Traverse Academy became the 99th school to finance with tax-exempt bonds.

In the course of charter school facilities financing to date, there have been 583 bonds issued across the U.S. (through May 2012) representing $6.44 billion in total (Exhibit 1). Relative to the municipal bond market of $3.7 trillion, though it has grown considerably, the charter school bond sector is still relatively small. Of the total 5,700 charter
schools in the U.S., less than 10% have accessed the tax-exempt bond market for their permanent facility financing\(^1\). To date, the default rate is approximately 2.7% out of $6.4 billion par amount of bond issuance.

The future of this sector will no doubt grow larger\(^2\) with the national conversation on education reform in the forefront of any discussion on improving our industrial competitiveness. As early entrants into this space, Hamlin’s ten year experience in this sector allows us to share with you our key qualitative and quantitative due diligence criteria in navigating this opportunity.

**State Legislation & State Oversight of Charter Schools**

Charter school laws originate within each state. As of December 2012, forty-two states and Washington DC have charter school laws. Alabama, Kentucky, Montana, Nebraska, North Dakota, South Dakota, Vermont and West Virginia do not. Charter school laws vary state by state. The strength or weakness of charter legislation greatly affects the success or failure of schools within their state. Every year The Center for Education Reform publishes a ranking and scorecard report on states’ charter school laws for promoting the growth and expansion of charter schools\(^3\).

One commonality among the states is the role of the authorizer\(^4\) in charter granting, oversight, and renewals or revocation. Each state appoints its own authorizing bodies to implement the charter granting. Authorizers can be either local school boards, state education boards, higher education institutions and/or independent entities. Charters are typically granted for a limited number of years where the duration differs state by state. Schools who receive charters are accountable to their authorizers, both academically and fiscally. Authorizers are frequently the sources of public disclosure regarding charter school performance.

Authorizers’ ongoing oversight determines whether schools receive charter renewals or have their charters revoked. The Center for Education Reform estimates that 1,036 charter schools or roughly 15% of the total number of charter schools opened since 1992 have closed. Because authorizers are major stakeholders in charter schools, Hamlin seeks to incorporate their perspective in each of our school investments. The relationship between the authorizing body and their charter school should be assessed in all bond financings.

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\(^3\) The Center for Education Reform –http://www.edreform.com/issues/choice-charter-schools/laws-legislation/

\(^4\) More information about Authorizers can be found from the National Association of Charter School Authorizers, www.qualitycharters.org/overview-interactive-map.
School Board Governance & Leadership

Every charter school is unique, and each charter school has a Board that is responsible for fulfilling the school mission and discharging its responsibilities. While there are many schools that are sponsored by national or regional network professional management teams, the super-majority of charter schools are managed independently. As with all organizations, the strength and composition of a Board is critical in the institution’s ultimate success or failure.

Assessing the leadership is a qualitative measure; it can involve looking at:

- leadership references,
- faculty credentials,
- faculty turnover,
- parent representation on Board,
- conflicts of interest disclosure,
- Board diversity by professional background.

Growth can also pose challenges. We have seen cases where the original school founders have had difficulty assimilating to more formal governance structures. Adoption of proper board governance is essential should a school wish to access financing through the tax-exempt bond market.

As stewards of public funds, conflicts of interests must also be managed. Hamlin prefers that conflicts of interest disclosures be required covenants of the bonding and managed throughout the life of the bond. The soft issues in charter school leadership and management cannot be taken too lightly; they play an important role in the overall culture and success of the institution.

School Enrollment & Academic Performance

Public funding for per pupil enrollment underlies the revenue source for all charter school financings. At the end of the day, hitting enrollment targets determines whether or not a school can meet its debt service obligations. What then drives enrollment? If you are a parent seeking better educational opportunities, you probably would choose to enroll in a school with better academic quality relative to the local district school. Recall that academic performance is the “accountability” measure in attaining the charter to begin with.

There are a few ways to gain insight into a school’s academic quality including but not limited to:

- authorizer report,
- multi–year state tests by grade,
- state adequate yearly progress report, and
- state/district comparable test scores.

But beyond these fundamental measures, another insightful factor is the wait list. This is the list of prospective students who would like to enroll but have not gained access through the lottery process. This phenomenon was
highlighted in the 2010 documentary film - “Waiting for Superman”- where families wait with nail biting anxiety to see if their child’s name is called from the pool of applicants in the lottery drawing. When all the spots are filled, the remaining students must go onto the wait list. Better performing schools have long wait lists. Although a helpful indicator of demand, the integrity of the wait list should be assessed as well.

School Financial Management

On average charter schools across the US are funded at 61 percent of their district’s peers\(^3\). This is not the only disadvantage. In addition, charter schools do not receive meaningful, if any, additional facilities funding nor public facilities to house their students. To offset that disadvantage, charter schools are not subject to local district collective bargaining agreements. Charter schools do have greater flexibility in prescribing curriculum, managing staffing costs, extending hours worked and a multitude of other arrangements that affect the cost-effective functioning of a school. Charter schools have taken on the challenge to do more with less, all the while accepting the academic performance accountability that comes along with it.

Charter schools that are able to borrow through bond financing to acquire and equip a permanent facility are fortunate. A facility that is built and equipped to suit the students’ education and activities needs represents one more step towards acknowledgement of the charter school’s established presence. But having a new debt burden introduces new challenges. School leaders must impose financial management process and controls in order to not only manage effectively, but also to satisfy their authorizer’s oversight and financial accountability to the public and to bondholders. Schools must submit annual audited financial statements in addition to next year’s budgets to their authorizers on regular scheduled deadlines. Most states have web sites showing charter schools’ report cards, and financial disclosures.

From the bondholder perspective, we analyze specific credit metrics to assess the ability of each school to service debt. They include but are not limited to - debt per pupil, enrollment trends, debt service as a percentage of revenues, and debt service coverage ratio (Exhibit 2). The funding of debt service payments is also important in our view. Arizona, Colorado, Michigan and Utah fund their charter schools from their state coffers directly to the bond trustee. We favor states with this direct deposit mechanism as it enhances the assurance of debt servicing.

Charter school bonds are secured not only by the pledge of gross revenue; they are secured by a first mortgage on the real estate. We also assess collateral valuation using debt per square foot, comparable sales and leasing activity in the local area.
Exhibit 2: Select Median Annual Financial Metrics of 298 Charter Schools

<table>
<thead>
<tr>
<th>Enrollment</th>
<th>Bonds Outstanding ($million)</th>
<th>Bond Debt Service Coverage</th>
<th>Maximum Annual Debt Service as % Revenue</th>
<th>Total Revenue ($million)</th>
<th>Total Expenses ($million)</th>
<th>Bond Debt Service ($thousand)</th>
<th>Revenue per Student ($thousand)</th>
<th>Debt Service per Student ($thousand)</th>
<th>Debt per Student ($thousand)</th>
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<tbody>
<tr>
<td>646</td>
<td>$8.62</td>
<td>1.45X</td>
<td>13%</td>
<td>$5.35</td>
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<td>$651</td>
<td>$8.12</td>
<td>$1.03</td>
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Hamlin strives to maintain a productive working relationship with our portfolio school leaders and their authorizers for on-going bond management. Hamlin also attends and participates in bond management panel discussions at state charter school association conferences. This outreach to the greater national charter communities builds upon our efforts to engender strong mutually beneficial relationships with charter leaders. We view this collaborative effort as a win-win strategy for all interest parties – bondholders, students, families, teachers, and the greater public.

The Future

That fateful day ten years ago in Grand Traverse, Michigan prompted our interest in this promising education sector. What we didn’t know then was that it will evolve into one of HCM’s investment cornerstones and affect the lives of thousands of American children for decades. As of December 2012, Hamlin clients own bonds issued by 68 charter schools with outstanding capital totaling $437 million. Collectively, Hamlin clients are housing over 50,000 kindergarten through 12th grade students across 16 states, with emphasis in the states of Arizona, Colorado and Michigan.

We are hopeful that the increased interest in this socially responsible investment opportunity will lead not only to enhanced oversight and transparency, but more importantly, to improved educational outcomes for America’s future. I hope to have piqued your interest in this subject.

Vivian Pan, Ph.D., CFA
Exhibit 1: Total Charter School Bond Issuance

Total Charter School Bond Issuance
($ in Millions)

Source: See Footnote 1