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Charter Schools and The Bond Markets

What Do Institutional Investors Look For In Charter School Bond Issues?

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What Do Institutional Investors Look For in Charter School Bond Issues?

Introduction

- **Who is AllianceBernstein and why do we invest in charter school bonds?**
- **What are the key determinants of a bond's credit worthiness?**
- **What kind of questions would an analyst like myself ask?**

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What Do Institutional Investors Look For in Charter School Bond Issues?

Charter Authorization

WHO ISSUES THE CHARTER? STATE-WIDE VS. LOCAL

- State-wide boards---consistency vs. political
- Universities---within schools of Ed or...?
- Local School Districts---how open-minded are they really to competitors?
- Local Governments---why? What do local politicians know that I don't?

WHAT KIND OF SCREENING PROCESS AND STANDARDS ARE THERE?

- Who can qualify? Joe the Plumber or only PhD's?
- How involved and frequent is monitoring?
- Does it go beyond what minimum state standards?
- What kind of assistance/support can the authorizer provide?

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Charter Authorization

HOW LONG IS THE CHARTER TERM AND WHAT IS THE REAUTHORIZATION PROCESS?

- Mismatch between term and bond maturity---the longer the term the better
- How early and aggressively do they intervene if something is wrong?
- What kind of early warning signs do they look for?
- What is the process to resolve issues? Is there right of appeal?
- How many charters have been revoked and why?
- Where do bondholders' rights come into the picture?
- Will they actively seek to assist in finding alternative users for the school?

BOTTOM LINE:

- Prefer active monitoring & ability to provide on-going support, such as from a university
- Dubious of local school districts as authorizer
- Early recognition of problems and intervention with assistance capabilities
- Full recognition that bondholders have rights

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What Do Institutional Investors Look For in Charter School Bond Issues?

State School Financing Law

WHAT ARE THE BASICS OF SCHOOL FUNDING IN A STATE?

- Is it fixed funding vs. negotiable with the sponsor/local district?
- Monitoring changes in state funding hard enough, but also at the local level?
- How much in state aid vs. local funding?
- Is there any funding for capital facilities?
- If budgets must be cut during a FY, are public and charter schools treated equally?
- Does the authorizer get a “haircut”?

WHAT KIND OF SECURITY INTEREST DO BONDHOLDERS HAVE?

- To whom are aid payments made?
- What is the timing of payments?
- What kinds of adjustments are made for enrollment as year progresses?
- Will the school need to cash flow borrow?
- If so, what kind of security is granted?

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What Do Institutional Investors Look For in Charter School Bond Issues?

State School Financing Law

BOTTOM LINE:

- Prefer predictable & monitor-able funding---ideally totally from state sources
- Aid should include some sort of capital cost
- Payments made directly to bond trustee monthly
- Debt service paid “off the top” (or at least from a set percentage of dedicated aid)

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Demand & Competition

WHAT KIND OF SCHOOL IS IT?

- Primary vs. secondary grades?
- How does the enrollment process work?
- Lottery? Preference to siblings? Geographic?
- What is the quality of facilities for competitive set---especially for higher grades?

WHAT IS THE DEMAND FOR THE SCHOOL?

- Historical enrollment trends for several years
- Has growth been organic, by grade, over the years?
- Wait list, by grade
- Annual retention from grade to grade

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Demand & Competition

WHAT KIND OF COMPETITION DOES THE SCHOOL FACE?

- How many other schools in the area---charter, public, private?
- What is the process for new charters to be authorized in the future?
- What is the quality of the local public school district?
- Socio-economic analysis of school service area
- How does its student-teacher ratio compare?

HOW HAS IT PERFORMED HISTORICALLY?

- Indicators of Performance, such as State report card
- Performance on standardized tests for all competing schools

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Demand & Competition

BOTTOM LINE:

- Established school with stable enrollment and large wait list
- Preference for organic growth in primary grades
- Stand-alone middle and high schools are a concern---student potluck
- Debt service covered without reliance on any, or only minimal, growth
- Performance---generally better than competitors
- An “A” school in a “C” district and not the other way around

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Financial

WHAT ARE THE KEY FINANCIAL METRICS?

- State reporting formats vary, but want to see audited GAAP financials
- Historic, positive operating results for at least several years
- Positive fund balances

HOW LIQUID IS THE SCHOOL?

- Cash in the bank, minimum of 30-60 days of operating expenses
- Cash flow projections and sensitivity analyses
- What are their cash management controls and policies?
- Do they have access to bank lines of credit and/or state cash flow assistance?

HOW WILL FUTURE NEEDS BE FINANCED?

- There needs to be funded reserve requirements for capital expenditures, repairs/replacement
- Ideally, fund raising capability is a plus
- Additional bonds? Under strictly limited circumstances

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Financial

HOW DO THEIR OPERATING EXPENSES COMPARE?

- What kind of room might there be in the budget to cut expenses?
- Are teacher salaries competitive or below market?
- What kind of services does management provide, if an outside management company is used?
- Management compensation---is it reasonable?

BOTTOM LINE:

- Solid proven, audited financial history
- Demonstrable ability to cover pro forma debt service with little / no growth
- Sufficient cash and revenue coverage to withstand either enrollment and/or aid declines for at least a year or two

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What Do Institutional Investors Look For in Charter School Bond Issues?

Management & Administration—Who? What? Why? How?

WHO IS INVOLVED?

- What is the background and what are qualifications of key managers?
- Would like to see distinguished academic and educational credentials
- Financial personnel **MUST** have extensive, school-related experience
- CEO must be as knowledgeable about the numbers as the CFO
- If construction is involved, what kind of oversight?
- Succession planning for key personnel

WHAT DO YOU OFFER?

- Private management companies vs. non-profit vs. stand-alone
- What is management getting paid?
- What are the key terms of management contract?
- **Fees?**
- **Performance standards?**
- **Ability of bondholders to direct termination and approval of replacement?**
- **Fees should be at least partially (if not entirely) subordinate to debt service**

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Management & Administration—Who? What? Why? How?

WHY WOULD A PARENT CHOOSE YOUR SCHOOL?

- Strategic plan and vision---what makes your school so special?
- Curriculum and educational philosophy
- Is the mission and vision supported by the facility?
- Science & Technology in a school with only one science class room? Doesn't work.
- Specialized curriculum vs. general?
- Uniforms? Discipline?
- Does it fill a niche or basic need?
- Needs of the student population---why teach yoga if they can't read?

HOW DO YOU MAKE IT WORK?

- What is the single greatest factor in contribution to student achievement?
- How do you measure staff performance?
- What kind of staff development programs do you offer?
- What kind of data do you gather for kids and staff?
- Teacher certification standards and compensation---must be competitive
- Staff turnover must be justifiable

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Management & Administration—Who? What? Why? How?

BOTTOM LINE:

- There needs to be clear and compelling reasons for the school to exist
- There needs to be proof of prior success and prudent financial management
- Jury is out on larger management organizations vs. stand alone vs. for-profit
- Bondholders must have a way to direct changes if school appears to be failing

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The Bond Deal

WHAT IS GETTING FINANCED? STAND ALONE SCHOOL VS. PART OF A SYSTEM?

- Stand alone---no start-ups absent some form of meaningful credit support
- Systems—joint & several, cross collateralization, typically rated

IS IT NEW CONSTRUCTION OR AN ACQUISITION?

- New construction
- **GMP contract, independent construction monitor**
- **Construction completion guarantees and/or protection against delays or cost overruns**
- **Environmental assessments, zoning & permits fully in place; land appraisal**
- **Borrower has demonstrated ability to manage process**
- Acquisition:
- **Was it built as a school or adapted from something else?**
- **Who owns it? A big conflict of interest if it is affiliated with management**
- **What is it being sold for? Made As Instructed appraisals give me no comfort**
- **Comps are mandatory**

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The Bond Deal

WHAT ARE THE KEY BOND TERMS & STRUCTURE?

- Deal does not necessarily have to be rated---yield is higher if it isn't
- Capitalized interest for reasonable period of time beyond construction
- Fully funded debt service reserve fund
- Must have mortgage and gross revenue pledge
- Ideally, per pupil aid payments go directly to trustee and debt service is paid "off the top"
- Lease structure acceptable ONLY as a means towards ultimate purchase
- No ground leases
- Additional debt---I want tight limits
- Ability of bondholders to direct process if things go wrong, including ability to find alternate user for facility if school fails
- Recognition by state that bondholders should get paid

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WHAT KIND OF FINANCIAL METRICS DO WE LOOK FOR?

- Debt coverage >1.20x,
- Debt service no more than 15-20% of expenses
- Days cash of >60 days
- Unrestricted fund balance >10%
- If school operated in lease facilities previously, debt service = prior lease payments
- Break-even analysis to show 1.0x with significant cut in enrollment and/or funding

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HOW DO WE MONITOR THE CREDIT?

- Disclosure!
- Annual audit one year late doesn't cut it!
- Essentially, whatever you give the state, bondholders want to see
- At a minimum:
- **Audit within 120 days**
- **Annual budget when adopted**
- **Quarterly financials with comparison to budget, within 45 days**
- **Enrollment and wait list information at key points in time**
- Cuts in aid during school year is a Material Event, arguably and so would large enrollment drops
- Agree to speak with bondholders as requested; ideally regular update conference calls
- Ignore the lawyers (just kidding)

HOW IS THE CREDIT GOING TO IMPROVE OVER TIME?

- We look for upside potential---non-rated becomes ratable, rating is upgraded