

Higher Education
Criteria Report

**Criteria for Rating Charter
Schools**

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■ **Summary**

Charter schools are public schools that are managed according to the terms of a contract or charter and offer parents an alternative school choice. Often, these schools are mistaken for private schools; however, charter schools are public schools. They are governed by a non-profit board of directors. The board of directors is usually composed of parents, local community members and business leaders, and educators. Charter schools are expected to meet or exceed performance goals or risk revocation of their charter to operate. They have the autonomy and flexibility to tailor education and curriculum programs to meet the specific needs of the students that they serve. Charter schools are created for many reasons, but primarily are created to be an alternative to the surrounding public schools.

■ **Main Characteristics of Charter Schools**

Main characteristics of charter schools include the following:

- Schools are exempt from state and district regulations.
- School founders are free to design education programs that serve the needs of their students;
- Schools must meet specific academic goals; if such goals are not met, charters can be revoked or not renewed.
- Schools have no taxing power and as a result, may go out of business unlike traditional public schools.

Some key similarities between charter schools and traditional public schools include:

- Charter schools are open to all students regardless of income and cannot discriminate.
- Charter schools are publicly funded per state law.
- Charter schools must meet or exceed state requirement standards which includes the No Child Left Behind act and also must administer all necessary state tests.
- Charter schools must abide by federal law regarding student health, safety, civil right, and student assessment.

■ **The Charter School Movement**

The first charter school opened in Minnesota in 1991, and the industry has experienced rapid growth since inception. Currently, there are 40 states and the District of Columbia that have charter schools. As of September 2006, about 4,000 charter schools were in operation across the U.S., serving more than one million children. Fitch Ratings expects the sector to continue to grow, especially in states with charter school-friendly laws such as California, Colorado, Arizona, Florida, Texas, and the District of Columbia.

■ **Fitch’s Criteria for Rating Charter Schools**

Historically, charter school debt has been primarily viewed as speculative, with a rating category of ‘BB’ or below. Limited capital funding from the local or state government or no funding, coupled with the lack of taxing power and the need to compete for students, have kept ratings low. However, many schools have since matured; operations and management practices have been strengthened, enabling many charter schools that access the capital market to achieve an investment-grade rating today.

When rating charter schools, Fitch reviews the following factors:

- Statutory environment within the state that governs the creation of charter schools.
- Relationship between charter school and charter granting agency.
- Enrollment history and projected trends.
- Local area demographic and economy.
- Financial performance and available fund balances.
- Management and administration practices.
- Current debt plans and future capital needs.
- Security provisions and disclosure practices to bondholders.

■ **Legal Environment**

State laws reflect differences in what the charter law allows and limits, which, in turn, have implications for charter schools within that state. As such, Fitch reviews the specific state statutes that create and support charter schools. Fitch reviews the legislative language to determine the level of state support for charter schools when creating, maintaining, and financing a school. Fitch looks for state laws that are supportive of charter schools, especially the state’s per-pupil funding formula.

In each state, charter legislation determines which agencies can grant charters. In some states, only the local school district can grant charters. In others, both local school districts and one or more additional agencies also can grant charters. In a third group of states, only one or more state-level bodies can grant charters. Fitch reviews the charter granting agency and examines the relationship between the agency and the charter school. A charter granting agency is usually a state-pointed board, a state university, or more commonly, a local school district. In the cases of when a school district is granting the charter, Fitch examines the two entities’ relationship and looks for

a supportive relationship. It is common for there to be competition between the charter school and the district schools. Again, Fitch looks for a close working relationship between the school district and the charter school. Fitch examines how the local school district views the charter school — as a challenge or as an opportunity.

Specifically, Fitch reviews and asks the following questions:

- How a charter is granted? Is the process clearly enacted in state statute?
- What is the term of the charter?
- How are charters revoked or renewed? Is the process impartial? Is a school permitted an opportunity to correct difficulties?
- What is the oversight process from the charter granting agency?
- Is the charter school a conversion school, as these schools can sometimes demonstrate a longer, more established presence in their communities?
- Is the funding stream from the state predictable and adequate?
- Does the charter school negotiate with the sponsoring school district to determine the per-pupil formula or is the formula set by state law?
- Does the per-pupil funding formula provide for capital needs?

■ **Enrollment and Local Area Economy**

Another crucial factor in Fitch’s analysis for charter schools is enrollment. A growing to stable enrollment level is extremely important, given that charter funding is based on student attendance. Fitch considers the following enrollment-related factors in the rating process:

- Solid enrollment and student retention rates since opening.
- Reputation for small class sizes and safety.
- Relationships with parents and community.
- Enrollment projections (reasonable management assumptions).
- Length and sustainability of the waiting list and how often the list is updated.
- Charter curriculum, whether it is unique or a core academic program.
- Location of school in a growing area.
- Quality of surrounding public schools.
- Type of schools of the surrounding competitors (traditional publics versus other charter schools).

- Dependence on enrollment growth to fund debt service.
- Breakeven point in enrollment in order to meet debt service payment.

■ **Financial Performance**

Another area that Fitch views as critical to the rating process is financial management and how resources are managed to fulfill the charter school’s mission. Most charter schools tend to close due to poor financial management and lack of proper internal controls. Fitch looks for stable to positive operating margins and growing fund balances. The fund balances provide financial flexibility if enrollment fluctuates or if unexpected needs arise. When analyzing a charter school’s financial performance, Fitch asks the following questions:

- What formula is used to determine per-pupil payment to the charter school?
- What is the charter school’s fund balance policy and does the charter school meet the policy?
- How quickly can the charter school reduce expenses should enrollment suddenly decline or if state payments are delayed?
- Does the state initially reimburse the school district for loss of revenues due to student movement to charter schools?
- What is the timing and frequency of cash payments to the charter school?
- Does the state have the ability to accelerate funding if the charter school experiences cash shortfall issues?
- Does the charter school have general business interpretation insurance given the single-site nature of charter schools?

■ **Management and Administration**

Fitch requires a site visit and management meeting when assigning the initial rating. This allows Fitch the opportunity to review with management the history of the charter school, as well as discuss current operations and understand internal controls. Site visits generally include a meeting with a member from the charter granting agency, charter school board members, and senior staff. The experience of key administrators is reviewed. Additionally, Fitch looks for demonstrated institutionalized management practices, as well as for expertise in area of education, finance, operations including curriculum development, bond financing, facility management, and construction. Furthermore, Fitch looks for a good succession plan to be in place since many of these entities are highly dependent on a few key administrators.

■ **Current Debt Plans and Security Provision**

Virtually all charter schools have had to overcome obstacles during their development. The majority of the obstacles have to do with limitation of resources, including funding for facilities, which is an area of great difficulty for charter schools. Initially, many schools either rent or lease space. However, once they establish a track record of successful operations, many seek long-term debt financing to build permanent facilities. Today, many state statutes permit charter schools to issue debt.

A key credit debt ratio that Fitch reviews is total debt burden relative to the operating budget. An annual debt service burden that consumes more than 20% of revenues is considered high. The strongest charter schools demonstrate the ability to meet future debt service with existing enrollment levels or very limited reliance on enrollment growth.

With respect to new construction of facilities, Fitch analyzes:

- Whether enrollment growth is needed to pay future debt service on bonds.
- If the charter school has the ability to meet current debt service payments with current enrollment.
- Whether additional facilities, such as athletic fields and gymnasiums, are needed to attract or maintain enrollment.
- If strong legal protections are available to bondholders, such as a general obligation pledge, a mortgage on the facility, a debt service reserve fund, and an additional bonds test.

■ **Document Requirements**

Enrollment and Demand

- Description of charter school’s history and founding.
- Total student headcount for the past five years.
- Waiting list segregated by grade level for the past five years.
- Retention and attendance rates.
- Number of staff and faculty.
- Description of current facilities.
- List of current competitors.
- Significant changes in neighborhood demographics.

Finances

- Audited annual financial statements for the past five years.
- Current year operating budget.
- Per-pupil allocations from local school districts and/or the state.
- Actual and projected debt service.
- Cash and investment balances.
- Any revenue projections.

Other Key Information

- Charter renewal history and description of charter renewal process.
- If an outside education management organization is used, copy of the management contract.
- Charter schools management biographies.
- Copy of current charter contract.
- Contact for sponsor district.
- Lease agreement.

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