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Public Finance Criteria: Charter Schools

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A charter school is an independent public school that operates under a charter or contract for a specified period of time to educate children according to the school's own design, outside of the existing public education bureaucracy. It may be a new school, a start-up school, or an existing one that separates from an existing school district. It is held accountable in terms of its charter and continues to exist only if it fulfills those terms. The statutory framework under which charter schools operate varies significantly by state and often requires the reauthorization of the charter by the sponsoring entity after a specified period of time, typically three to five years. The first charter school opened in Minnesota in 1991.

Charter schools pose unusual analytical challenges. Public school districts and charter schools differ in critical ways. Public school districts must remain "going concerns", regardless of management performance or economic environment. Financial stress does not cause a public school district to go out of business, and may even generate positive counter-measures due to state oversight and support. In addition, public schools do not need to get their charter renewed periodically to stay in business. In contrast, charter schools may permanently go out of business. While there is not a long history with which to judge sector performance, charter schools that close largely do so because of financial mismanagement.

Standard & Poor's approach to rating charter schools depends on factors affecting each local school, as well as the state legal framework for authorizing and funding charter schools from statewide revenue sources. Rating criteria will vary from state-to-state and continue to evolve, because each school and state charter structure is very different.

Standard & Poor's rating methodology for both school districts and charter schools includes an overview of the following:

- Administration and management factors,
- The service area economy,
- Financial factors, and
- Debt structure.

However, the magnitude of importance for each of these factors shifts when looking at charter schools. Specifically, economic factors only contribute to the extent that they promote a stable or increasing population of school age children, since revenues derive largely from state formulas based on enrollment figures, and debt service is not repaid from a tax levy on district property. Conversely, management factors take on a much more critical role, because a charter school cannot levy taxes. Its existence therefore depends on its ability to attract fundamental demand for its services. A charter school does not have the security of never going out of business. Additionally, charter schools may have to contend with construction risk issues. School district debt is usually supported by property tax receipts, which are not dependant on completion of a project or facility. However, because charter school funding is strictly tied to enrollment, construction delays could significantly impact timely school opening, dramatically affecting enrollment levels, and thus overall financial operations. To accommodate these and other rating factors, Standard & Poor's has added three broad areas for review, representing a blend of public school district and independent private school criteria.

The three areas where Standard & Poor's rating approach differs substantially from traditional public education credit analysis include: (1) State statutory framework, including charter authority and the role of the charter school authorizer, (2) charter school financing and (3) student demand analysis. Additional credit factors are analyzed for charter schools in regards to finances, management and administration, debt and capital plans, and socio-economic factors.

State Statutory Framework

An important ingredient of a creditworthy charter school includes a clearly established state statutory framework for establishing, maintaining, and financing charter schools.

Charter authority

Standard & Poor's examines who, under statute, has the authority to grant charters. Powers are usually vested with a state-appointed board, a state university, or most commonly, a local school district. When a local school district is granting the charter, Standard & Poor's needs to feel comfortable that the school district supports the charter school, since the two may compete for the same students. Local school districts may support the charter school for varying reasons, such as relieving new building needs in growing districts, or providing a unique educational curriculum not currently provided. The number of charter schools and competing new entrants that are allowed by statute or may be established in the future is an important demand consideration. In some cases, a local school district official may serve on a charter school board, enhancing support and integration of the charter school with the local school district. In other cases, a state or a university that does not actually compete directly with a local school district may grant the charter.

State legal framework

An impartial legal framework for charter renewal or revocation, including a right to appeal a charter non-renewal, contributes to more uniform results. A clear renewal and appeal process should diminish the political elements involved in establishing or maintaining such schools, while ensuring adequate community input.

Some states also provide capital funding for charter schools, enhancing the ability of a charter school to fund its debt.

Charter term
The charter term is an important credit factor. The state statute will either limit the term or establish the entity that is charged with granting the charter term. Charter schools are often granted charters of limited terms—typically up to five years—and thus are subject to periodic renewal evaluations. Charters can usually be revoked even prior to the end of the charter term, usually for cause. While charters may only extend for five years, longer-term capital financings are generally amortized over a 20-30 year term. A good match between the charter term and bond amortization may contribute to a better rating, although Standard and Poor's does not require long charter authorization periods for an investment grade rating. A school with good financial operations and stable enrollment is likely to remain a going concern, and thus a shorter charter term relative to debt maturity can be acceptable. Schools that have been through the charter renewal process at least once support the assumption of future successful renewals, and are most likely to be rated investment grade.

In general, Standard & Poor's feels the periodic need to renew a charter does not necessarily pose a major risk to receiving an investment-grade rating. A successful charter school with high demand for its product will have its charter renewed, much as successful hospitals will have their operating licenses renewed if they meet a community need. Closures of charter schools generally follow from management or financial disorder, not from the arbitrary closure decision of the authorizing body.

The role of the charter school authorizer.
The charter school authorizer plays an important role in determining credit quality. Nearly all of the investment-grade charter schools rated by Standard & Poor's have been through a successful charter renewal process, although schools that have not been through the renewal process may still merit an investment-grade rating. A long-term charter could be a positive rating consideration. In addition, a school that has received interim charter approvals as new grades are added or programs changed will be considered to have gone through a process similar to a charter renewal. Standard & Poor's focuses on the following questions when evaluating the authorizer as part of a credit review:

- What are the guidelines for charter renewal? If this is a detailed and specific process, there is less room for arbitrary revocation.
- What is the history of charter revocation in the state and for the specific authorizer? Have a sponsor's charter decisions been appealed?
- What is the level of oversight from a financial reporting and facilities planning standpoint? Is there a formalized financial reporting and oversight process during the fiscal year that allows for corrective action to be taken in advance of charter review time frame?
- Is there a role for the authorizer in providing liquidity or credit enhancement relating to short or long term debt issuance? This could be a positive credit factor.
- Is there an interim charter renewal period when grades are added or triggered to some other event?
- What is the relationship between the sponsor and its charter(s) over time? What level of academic, planning or administrative support is available?

The strongest sponsor/charter relationships will have formalized coordination and reporting in place, and good communication that allows quick resolution of any academic, policy, facilities or financial issues that arise. As part of the rating process, Standard & Poor's will typically meet with officials from both the sponsoring entity and the charter school.

Charter School Financing

A key part of the analysis deals with the funding mechanism for charter school operation, i.e., whether a combination of state or local funds will be predictable and adequate. Many states simply finance students in their charter schools at the same per-pupil funding level of traditional public schools, while others leave the funding formula to negotiation with the sponsor. In some states, charter schools get less funding per pupil than for public schools and receive no public funds for capital facilities financing. While each state's formula for distributing funds to its charter schools differs, the strongest systems occur when the state standard per-pupil funding of public schools follows the students to the charter schools. Additionally, per-pupil funding may flow-through a sponsoring district, or come directly from the state.

Standard & Poor's will evaluate the funding mechanism and payment requirements to determine if cash-flow difficulties of a sponsor, such as a sponsoring school district, could create cash-flow difficulties at the charter school. A stand-alone charter school typically has less flexibility to withstand funding reductions or timing delays than a traditional multi-facility and multi-grade public school district.

The statutory authorization for issuing charter school debt needs to be clear. Specific funding under statute for facilities is also evaluated and considered a credit strength. Some states provide direct funding for facilities, while others provide statutory authorization for local school districts to provide facilities funding.

Student Demand

Student demand for the charter school is one of the key elements of a rating evaluation. State funding generally follows pupil attendance for most charter schools. Charter schools need to demonstrate a record of demand for their educational services, as measured by stable-to-increasing enrollment, in order to retain funding.

Specifically we look at the following:

- A well-documented waiting list that is regularly updated and maintained. Which is particularly important if the charter school is issuing debt to significantly expand its facilities. The quality of waiting lists will vary dramatically depending on its requirements (e.g., the age of the list, the level of detail required per applicant, parent volunteer time agreed to serve upon enrollment acceptance, etc.).
- An overview of competition in the area that affects the long-term viability of the school. This would include an analysis of other charter schools currently operating in the area and whether competing new charters could be authorized in the future. Additional analysis of other private school alternatives in the area is also done. Forecast assumptions should be based on reasonable well laid out assumptions.
- A charter school enrollment trend that is stable or growing is also preferable.

Unlike private independent schools rated by Standard & Poor's, charter schools are required to maintain open admissions policies. If demand exceeds supply, most charters use a lottery system to fill available spaces.

Unusual curricula present a challenge in the rating process. Standard & has to determine whether a unique academic focus is relevant to the community and will continue to attract students. Another challenge associated with charter schools is an absence of recreational and student facilities typically found in large suburban high schools or private independent schools. Limited athletic facilities and related programs can significantly hamper recruitment efforts for older students, particularly those in high school and junior high, although they may reduce charter school operating costs. Some charter schools have the ability to charge a facilities fee; others cannot. Some charter schools may be able to coordinate with their local public school districts to provide recreation programs.

Financial Factors

The charter school's own management of its resources is a key determinant of its creditworthiness. Since most charter schools are likely to be small, there will be fewer opportunities to realize economies of scale; therefore, careful financial management is critical. Of particular importance is the formula by which revenues are derived. Revenues in some states are not always determined on a per-pupil basis. Other financial factors include:

Operating history

Investment-grade rated charter schools will likely have a financial operating history. A track record of stable operating performance for a minimum of at least three years is a critical factor for an investment-grade rating.

Fund balance

Fund balance reserves are critical due to charter school reliance on enrollment for funding. Enrollment can—and does—fluctuate, while fixed costs may not. Standard & Poor's looks to see if there is a formal fund balance policy based on cash flow requirements, and whether the school successfully adheres to such policies.

Financial flexibility

The ability to reduce budgets, if necessary, also contributes to financial flexibility in the event of an unexpected downturn in enrollment, as do conservative budgetary policies. Standard & Poor's routinely asks charter schools how they would maintain a balanced operating budget if enrollment dipped or state funding were delayed or reduced.

General financial policies

An overview of insurance policies, including both casualty and business interruption insurance will be evaluated because charter schools often use a single site facility. Existence of long-range financial and facilities planning, and formalized policies relating to fund balance and cash-flow reserves are also positive management and financial factors.

Audits and financial reporting

While Standard & Poor's strongly prefers independent audits, we have rated schools that are presented as a component unit of a school district that is also the authorizer. Availability of independent audits—at the charter school level—may be a critical rating factor in determining investment grade ratings. Uniform financial reporting is important for fiscal accountability and also factors into charter renewal decisions.

Cash management
Cash management policies and procedures are important. The frequency and timing of payments to charter schools throughout the year varies by state, which may affect daily cash flow. Banking relations will also be reviewed because access to liquidity is important as financial reserves tend to be modest and cash flow requirements can be uneven. While some states have provisions to accelerate funding to charter schools, other states, have no such provisions.

Renewal and replacement reserves
Existence of a formal reserve for future renewal and capital expenses that is funded within the operating budget each year, is considered a positive credit factor.

Endowment/fundraising
Is there an established endowment or fundraising program? The existence of such a program may contribute to financial flexibility.

Management and Administration
Management factors are a critical part of charter school review and will be a pivotal factor in determining if a school is investment grade.

Standard & Poor’s considers the history of charter school establishment. Biographies of key staff members may indicate the depth of the management team. Key staff should have solid experience in financial management in addition to the expected academic/educational credentials, or an experienced management company or public school district staff should provide such expertise. Charter school management is expected to have—or — construction management expertise, as needed. In situations where the success of the charter school is closely tied to the charisma and personality of a founder, succession planning is necessary to ensure ongoing viability of the school.

Private management contracts are commonly used across the country. This is generally credit-neutral as long as the management company is experienced and the terms of the management contract do not adversely affect bondholder repayment.

Details about the budgeting process are important financial management issues, and Standard & Poor's looks to see if management been generally accurate in its enrollment and cost projections. Information regarding teacher recruitment is also critical, as well as teacher certification, salary scale comparisons with the local school district and competing charter schools, how teachers are recruited, certification requirements, comparative salary scale, and turnover.

Debt and Capital Planning
Many state statutes specifically authorize charter schools to issue debt. Capital financing for charter schools, however, is in its infancy compared to other municipal rating sectors. Many states have not yet developed an active public debt market for charter schools. Although charter school facilities financing varies substantially from state to state, many schools are left to their own resourcefulness and the diligence of interested community members to secure and finance adequate facilities.

Some traditional debt measures for public schools are used to assess debt burden or overall leverage of charter schools. Specifically, Standard & Poor's looks at the debt service burden relative to the operating budget. An annual debt service burden of more than 20% of expenses would be considered onerous in most cases. This is probably one of the more critical measures, because a high fixed cost for debt service can significantly limit fiscal flexibility. Any charter school expecting to raise its debt levels needs to demonstrate an ability to pay for the increased debt service, especially if the revenues are expected to come from enrollment growth. The strongest charter schools can demonstrate ability to meet future debt service with existing enrollment levels or very limited reliance on enrollment growth. An example of limited reliance on future growth might be the addition of an extra grade level, which current charter school students may graduate into.

Using a lease structure at the lower end of the credit spectrum may not be considered a material credit weakness, although it is preferable to have a general obligation pledge of the charter school in addition to a mortgage on a school building. Charter school lease structures must meet Standard & Poor's lease criteria. Basic security features such as appropriate debt service reserve funds, additional bonds tests, use of a trustee to hold bond funds, and similar security features should be incorporated into the financing structure. Legal covenants such as a rate covenant are not relevant to a charter school—the school cannot set tuition, but receives state revenues. A charter school usually can only increase net revenues by increasing enrollment or reducing expenses.

Standard & Poor's also considers what future capital requirements and other projects will be necessary to keep schools viable and competitive. How will annual maintenance requirements be handled as part of the operating budget? Charter schools are at a disadvantage compared to public schools, because their state operating revenues might also be needed for paying debt service—in contrast, public schools enjoy a separate property tax levy for debt service.

Also of concern are the debt issuing provisions of the entity providing the charter authorization. Is it actively involved and does it have an approval role on projects under consideration? Does the authorizer have guidelines regarding facilities or debt structure?

Future debt service coverage margins are evaluated but may be of limited value compared to a demonstrated ability to manage budgets and generate revenues. Projected budgets should adequately provide for future debt service payments plus a margin for unexpected financial fluctuations. Identifying areas of the budget that could be cut would be an advantage and may serve the purpose of providing a hedge against potential drops in enrollment. Standard & Poor's prefers projections indicating a coverage margin on new debt. However, the unique nature of charter schools, which receive the bulk of their revenues from government, as opposed to tuition receipts, makes coverage less important as revenues benefit from the solid credit quality of the state providing the funding. Revenues will be stable due to stable state funding stemming from stable enrollment, not from tuition setting power.

Charter schools that finance facilities to accommodate significant additional student enrollment growth will usually have greater difficulty achieving an investment-grade rating. Facilities construction risk is present if debt service is onerous and debt repayment is limited if the facility does not open on schedule or over budget. Demonstrating demand for an expanded facility becomes increasingly difficult as the anticipated percentage increase in enrollment grows.

Socioeconomic Factors

Traditional economic indicators for general obligation public school districts—such as income, employment base, and unemployment rates—are less of a credit issue for charter schools than for traditional public schools because charter schools are not directly tax supported by the local economic base, but by statewide school funding appropriations. Demographics of an area serviced by a charter school are nonetheless analyzed, particularly population growth. Historic and projected student enrollments are an indicator of overall education demand. A rapidly growing area is generally more capable of supporting education alternatives in order to meet demand for facilities. However, a charter school can be successful in a slow or declining enrollment environment if public school options are substandard and the charter school represents a more attractive alternative curriculum. In some cases, the attraction of a charter school over a public school may be simply the amount of discipline being offered, or maybe a less structured environment. Some public school districts view charter schools with specialized curriculum options as almost another kind of magnet school within the overall public school system, and worthy of their support.

Charter School Information Requirements

Relevant demand information

- Description of school's history and founding
- Total student enrollment (for last 5 years)
- Current year and future enrollment targets
- Number of students on waiting lists (for last 5 years)
- Measures of educational outcomes (test scores, performance on standardized tests)
- Number of faculty and staff
- Description of current facilities (if more than one location, indicate number of students
- Number and description of close competitors

Relevant financial information

- Sponsor (names and addresses of key contacts)
- Charter School management biographies
- Current charter provisions (term and funding levels)
- Charter renewal history and description of charter renewal process
- Audited financial statements (or independent financial reports for last 3 years)
- Current year operating budget
- Description of funding mechanism and cash flow
- Description of any fundraising activities, public or private gifts or grants
- Revenue projections (including estimated enrollment, revenues, expenses, and debt service coverage)

Other documentation requirements

- Sources and uses and debt service schedule
- Description of bondholder security
- Offering statement/disclosure information
- Independent property appraisal (market value assessment of completed project and land may be required)
- Independent site assessment (may be required)
- Lease agreement
- Trust indenture

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