ADDRESSING CHARTER SCHOOL FACILITY NEEDS

Actions for States

Executive Summary

State policymakers can help public charter schools overcome obstacles to their stability, growth and ability to provide high-quality options to students—simply by providing these schools with access to affordable financing to build their own facilities.

Ownership is a critical option to address charter school facility needs. Most charter schools pose little risk of defaulting on a building loan, given their specific circumstances and strong academic performance. Yet, these charter schools face the same high interest rates paid by the riskiest businesses. This forces most charter schools to lease instead of buy facilities, consequently redirecting resources that could otherwise go toward instruction.

State policymakers can take three steps to help charter schools get affordable facility financing. First, states can back bonds for charter schools, which will lower interest rates. Second, states can prevent arbitrary revocation of charters, creating strong conditions for charter school quality and investor confidence. Third, states can provide short-term no- or low-interest loans for new charter schools.

Introduction: Facilities Present an Enormous Challenge for Charter Schools

Lack of access to affordable facilities is one of the most critical issues facing public charter schools in every state across the country.[1] Most states do not provide facility support for charter schools. They also lack the power that traditional school districts have to raise taxes for facilities. As a result, charter schools are forced to use operating funds to pay for facilities. These operating funds, which are already lower than what traditional public schools receive, would have otherwise been spent on instruction.[2]

Currently, facilities challenges deter new charter schools from starting up and prevent existing charter schools from expanding to serve more grades, more students or additional campuses. Facilities challenges are a major driver in the decline in charter school growth, while many cities face tens-of-thousands of families on waiting lists to enroll in charter schools.[3]

This issue brief explains how state policymakers can reasonably and effectively address the critical facility needs of charter schools: by helping charter schools secure affordable financing needed to own their buildings. First, the brief explains why ownership is a critical option to address charter school facility needs. Second, it describes why charter schools face a severe problem in accessing affordable financing for facilities. Finally, the brief provides three steps policymakers can take to help charter schools get affordable facility financing.

Why Ownership Is a Critical Option to Address Charter School Facility Needs

For many public charter schools, owning their own facilities is a key to their stability, growth and ability to serve an increasing number of students in need of high-quality school options. Facility ownership means that charter schools are not sending public tax dollars, year after year, to private landlords. Instead, charter schools are building equity each year. When charter schools own their buildings, they create assets that benefit the public in the long run.[4]

---

[1] See Education Cities, *Quarterback Role in Facilities Strategy* (2018).
[2] See Charter School Facilities Initiative (CSFI), *Charter School Facilities Initiative Initial Findings from Twelve States* (2013); University of Arkansas, *Charter School Funding: (More) Inequity in the City* (2018).
[3] Arianna Prothero. "Growth of Charter Schools Is Slowing Down. Here's What's Behind the Trend," *Education Week* (Jan. 30, 2018); Center for Reinventing Public Education, *The Slowdown in Bay Area Charter School Growth: Causes and Solutions* (2018).
[4] Ownership benefits exist even when the charter school building is owned by an affiliated organization, as it sometimes required under state law. The charter school can remain in the building as long as it wants to, and lease payments should be lower than renting from a private landlord.

Ownership offers charter schools long term stability, and it insulates schools from arbitrary termination of leases. A handful of states encourage school districts to rent out their surplus buildings to charter schools. However, the leases for these facilities are typically for short periods of time. Charter schools may even get kicked out if their district needs the space or—because of a change in district leadership—becomes hostile to charter schools. (Districts often view charter schools as competition.) As the number of charter schools grows, districts may prove less able or willing to make facilities available. Additionally, public charter schools can outgrow the facilities provided by districts.[5]

Even when states provide annual facility allotments to lease facilities, as a few states do, charter schools often have difficulty finding suitable space.

Unlike a house, schools are not common structures. Landlords may also charge high rents, much higher than what it would cost a charter school to build its own building.[6] This difference could pay for many additional teachers in the classroom. Alternatively, charter schools may end up in nontraditional spaces, like storefronts, which lack some of the important features of buildings designed as schools.[7]

As shown in Table I below with variance across states, less than one quarter of charter schools own their facilities, more than half rent and the remainder are located in facilities provided by the district or some other entity.[8]

Table I: Facility Status of Charter Schools by State

State	Own	Rent	District
Arkansas	11%	63%	11%
California	9%	42%	44%
Colorado	43%	26%	26%
Delaware	50%	43%	4%
Georgia	23%	51%	26%
Idaho	34%	42%	17%
Indiana	20%	80%	0%
Louisiana	19%	21%	60%
Massachusetts	33%	58%	0%
Michigan	41%	49%	3%
New Hampshire	0%	80%	17%
New Jersey	18%	72%	8%
New York	7%	40%	43%
Oklahoma	15%	30%	50%
Rhode Island	30%	45%	5%
South Carolina	16%	38%	26%
Tennessee	11%	50%	17%
Texas	36%	45%	6%

[5] Also, the facilities offered to charter schools often need significant repairs or modifications, as they are in older or inadequate buildings. Financing is needed to pay for these changes.
[6] As explained below, the typical rent for a charter school is $1.2 million annual; whereas, low-cost financing of a building is $1 million per year, or 20 percent less.
[7] For many nontraditional spaces, charter schools need to make substantial enhancements, which requires financing.
[8] These are all the states for which figures are available through the various reports by the Charter School Facilities Initiative.

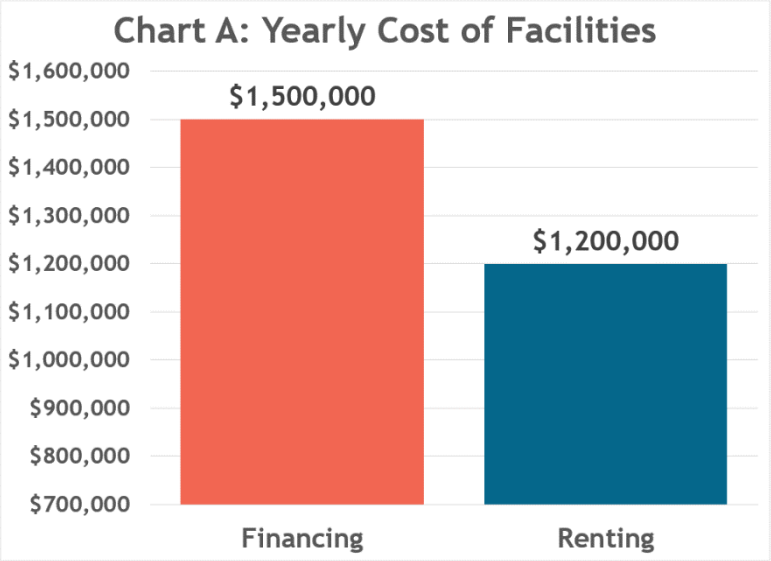
Why Ownership Is Helpful to States and Communities

Facility ownership is not only helpful to public charter schools, but to states and local communities. If a majority of charter schools can build their own buildings, billions of dollars in investment will take place that otherwise might not exist. Hundreds of new buildings will go up, each of which will generate economic benefits in its community. Rather than sending public dollars to private landlords, each new building that goes up will create permanent equity that will benefit communities for the long-term.[9]

Why Policymakers Need To Help Charter Schools Buy Facilities

The primary reason most charter schools do not own their school buildings is a lack of affordable financing. Few, if any, charter schools have the $10 million or $20 million in cash needed to buy a building outright. As such, the ability of charter schools to address their facilities needs depends on their ability to borrow money at a reasonable cost. Yet, under current conditions, many charter schools are asked to pay so much for financing that it is better to rent.

As illustrated in Chart A, a typical charter school may have to pay $1.2 million in rent each year. If the school wants to own its building, financing will cost about $1.5 million— much higher than rent. This is because of the high cost of financing available to many charter schools.[10]



Why is financing so expensive? To understand the problem, it is important to understand the basics of how facility financing works, and why it is not working effectively for most charter schools.

Charter Schools Are Forced to Pay High Interest Rates

The best way for charter schools to borrow money is generally through tax-exempt bonds. The money from bonds comes from investors who buy the bonds and require repayment of the borrowed amount, or principal, plus interest. Multiple investors will buy pieces of the total amount of the bond (e.g., one buys $1 million, another buys $2 million, out of a $15 billion bond). These investors can be banks, mutual funds, foundations or individuals.

[9] As a condition of state backing, states can require that charter school facilities built with state support always benefit the community. If a charter school no longer needs a building, it can be offered to other charter schools or it can be sold, with the proceeds, after debts are paid, kept for a public purpose. This is what generally happens when traditional districts schools sell their buildings.

[10] Charter schools pay about 10 percent of their operating budgets on rent, unless they are in district-provided facilities. This does not include facility-specific revenue, estimated at an additional 2 percent. See Charter School Facilities Initiative (CSFI), *Charter School Facilities Initiative Initial Findings from Twelve States* (2013). CSFI provides similar data on other states in more recent reports. This illustration is for a charter school with 1,000 students and operating revenue of $10,000 per student, for a budget of $10 million per year. Financing is for $14 million at an interest rate for financing is 8 percent, and fees equal to another 2 percent. As explained in greater detail below, this is what a typical charter school might have to pay with tax-exempt financing without state backing. To calculate annual payments based on different interest rates, see SF Gate, *How Do I Calculate Mortgage Payments in Excel?*

Tax-exempt bonds are advantageous for the following reasons:

- *Earnings from bonds are exempt from taxes*, meaning investors do not have to pay federal—and often state—taxes on the interest they earn. Consequently, investors are willing to accept a substantially lower interest rate.
- *Bonds are typically repaid over 30 years, with a fixed, or unchanging interest rate*. In contrast, regular loans may only be for 5 or 10 years; after that, the charter school will need to get another loan, and the interest rate may be higher.
- *Bonds facilitate growth*. Charter schools can sell more bonds as needed without having to get permission from previous lenders; whereas, regular loans require such approval before borrowing more money.[11]
- *Charter schools can often use bonds to borrow 100 percent of the cost of a facility*, including costs during construction. Traditional loans rarely exceed 80 percent of total costs.

Tax-exempt bonds are the standard way traditional districts borrow money to build their schools. However, unlike traditional public schools, public charter schools face high interest rates for financing them. One reason for the higher interest rates is because of the ratings assigned to charter school bonds. Standard and Poor's, or S&P, is one of the main rating agencies used for charter schools.[12] It is extremely hard to get a good rating from S&P for the following reasons:[13]

- *S&P views all charter schools as a risky proposition*, regardless of which state or the situation of a specific charter school. They focus on the length of charter agreements, which are typically shorter than the term of bonds and can be non-renewed for arbitrary reasons, including change in political leadership at the state or local level.
- *For specific charter schools, S&P has additional difficult criteria*. For example, any school smaller than 1,000 students is considered "vulnerable." Charter schools are also expected to have as much as a year of cash on hand and to operate on a "surplus" as high as 20 percent. It can take many years for a charter school to achieve this financial situation, if it ever can.[14]

For the most part, **the only charter schools that can run this ratings gauntlet successfully are those run by well-established charter management organizations** (CMOs). CMOs manage multiple charter schools and seek to expand the number of schools through replication, using their other schools as collateral. However, there are many groups, including parents and teachers, who want to establish new schools. These independent charter schools are an important source of innovation and can address the unique needs of a diversity of students.[15]

Interest rates for charter schools reflect ratings that fundamentally undervalue the importance of academic quality and performance of the specific charter school seeking a bond.

The vast majority of charter schools pose little risk of default, given their specific circumstances and strong academic performance. If a credible authorizer has confidence in the academic quality of a charter school, that school is almost

[11] Charter schools still must follow criteria for taking on more debt that are established when the bond is issued.
[12] S&P provides most ratings for charter schools. Moody's and Fitches also provide ratings.
[13] For more on ratings, see the Appendix.
[14] See S&P Global, *U.S. Public Finance Charter Schools: Methodology and Assumptions* (2017); Interviews with Jim Griffin, Momentum Strategy & Research (Apr. 12 & Nov. 2, 2018).
[15] Charter schools are often advised to avoid the cost of getting a rating in the first place, unless they are likely to get the highest rating.

certain to survive and thrive, even it is only two or three years old.[16] Only a tiny percentage of charter schools nationally close each year. All the rest have stable futures. Yet, these charter schools face the same interest rates paid by the riskiest businesses, aka "junk" bonds. These interest rates make it more expensive to finance than rent.[17]

Charter Schools Are Forced to Pay High Fees to Enter the Bond Market

In addition to high interest rates, borrowing through bonds often also requires charter schools to pay high fees. Public charter schools, unlike traditional public schools, are not allowed to go directly to the bond market.[18] Instead, charter schools must go through a state-approved intermediary, called a conduit issuer.

Almost every state has established one or more conduit issuers for charter schools. The involvement of these conduits does not mean that the state is backing the bonds in any way, although the conduits can provide an important layer of due diligence. However, the conduit issuers charge significant fees, including for a legal opinion (by bond counsel) supporting the tax-exempt status of the interest payable on the bond and assuring that the bond was properly issued.

Charter schools also need an underwriter, or placement agent, usually an investment bank, which will interact with prospective investors. These underwriters are important gatekeepers that assess the general credit worthiness of charter schools. They must draft an official statement for each bond describing the financial merits. The statement is time-intensive and expensive. The charter school must also pay for a legal opinion as to the accuracy of the statement and compliance with federal securities law.[19] **The process is complex enough that many charter schools need to hire a financial advisor**. Finally, in many instances, charter schools need to pay to have their bond rated by Standard and Poor's or another firm. Ratings are discussed in greater detail below.

The fees for these various services are high, raising the cost of financing significantly. Also, no matter how small the bond, the fees will not go below a high, minimum amount. This can really hurt a significant cross section of charter schools, including rural charter schools and new charter schools, which only need smaller bonds (e.g., $5 million or lower). On top of this, these same charter schools are charged higher interest rates, as explained above.[20]

What States Can Do to Help Charter Schools Get Affordable Facility Financing

High interest rates and fees significantly deter bond financing for charter schools, because they make the cost of ownership higher than renting. Only about 10 percent of charter schools have accessed bonds.[21] Beyond the elite 10 percent, there are at least another 60 or 70 percent of charter schools with established track records and growing student populations. These charter schools poses little or no risk of closing or defaulting on loans. **With three steps, states can dramatically improve access to affordable financing for these charter schools.** By doing so, states can save charter schools huge amounts of money at a low cost while simultaneously encouraging more investment in the state.

---

[16] Charter School Capital, *Charter School Facility Financing: Understanding Bonds* (2018); Local Initiatives Support Corporation (LISC), *Charter School Bond Issuance: A Complete History Volume 2* (2012); Charter School Advisors and Local Initiatives Support Corporation (LISC); *Charter School Bond Issuance: A Complete History Volume 3* (2015).

[17] About 3 percent of charter schools close each year. See National Alliance for Public Charter Schools, *Estimated Public Charter School Enrollment, 2017-18* (2018); National Alliance for Public Charter Schools, *Estimated Public Charter School Enrollment, 2016-17* (2017); National Alliance for Public Charter Schools, *A Closer Look at the Charter School Movement* (2015).

[18] In a few states, like in Michigan, charter schools can go directly to the bond market. Michigan has seen an inordinate number of bond defaults, for unrelated reasons.

[19] See Venable, *Tax-Exempt Financing for Independent Schools: Is Your School Eligible? Do the Benefits Outweigh the Costs?* (2013).

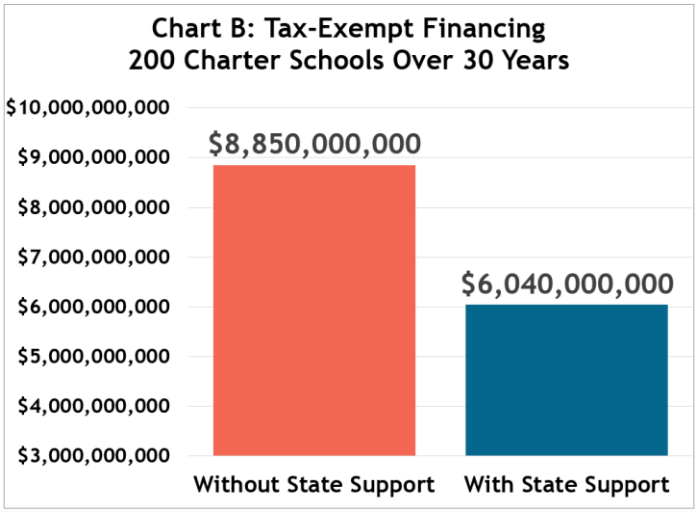
[20] Interview with Mark Medema, National Alliance for Public Charter Schools (Nov. 9, 2018); Clark-Herrera *et al.*, *Public Charter Schools Borrowing With Tax-Exempt Bonds*, Third Edition, National Alliance for Public Charter Schools & Orrick (2019).

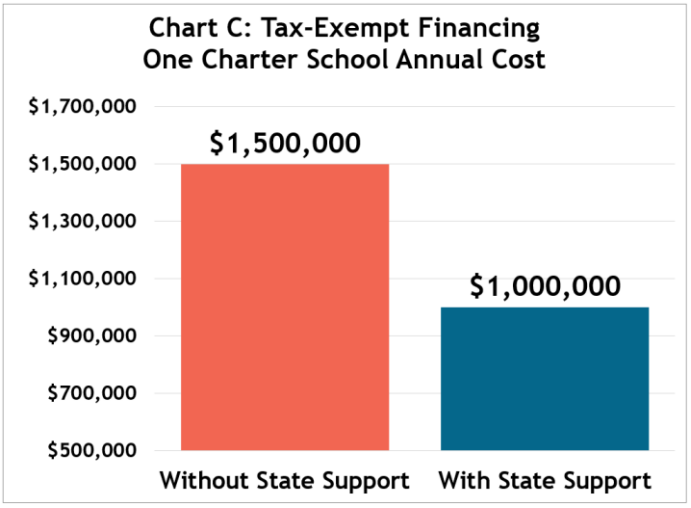
[21] Overall, 1,300 bond issuances have occurred, concerning about 700 schools, out of more than 7,000 charter schools. Interview with Wendy Berry, Charter Impact Fund (November 13, 2018); NewOak, *Charter School Bond Sector: 2017 Year in Review and 2018 Outlook* (2018).

1. Guarantee Charter School Bonds and Reduce Fees

First, states can guarantee or back bonds for public charter schools. Chart B illustrates the cost of financing for 200 charter schools in a state over 30 years. Without state support, the cost is $8.8 billion. With state support, the cost drops to $6 billion, or $2.8 billion less.

If the state guarantees these bonds, it will have to pay for any defaults that occur. The default rate is 1.3 percent for bonds issued under current underwriting standards.[22] Even if the default rate increases to 2 percent, the state will possibly have to pay $56 million. In other words, for cost of up to $56 million *over 30 years*, the state can save charter schools $2.8 billion. This is more than $500,000 in savings for every charter school, every year in the state, as shown in Chart C. In other words, while defaults will happen, the states can view the cost of defaults as by far the most cost-effective way to address the facility needs of students in charter schools. Charter schools can redirect these resources into instruction.





For example, **Arizona** recently enacted a bond guarantee program that allows a broad cross section of charter schools access to state support. Arizona will back bonds that are less than investment grade, placing higher weight on academic quality and supporting smaller schools and schools with lower cash reserves and surpluses. Up to 25 percent of support can go to charter schools that have at least a B- S&P rating; the rest is for charter schools that have at least a BB- rating. This program is a model for other states on how they can responsibly back bond financing for a large majority of charter schools.[23]

A handful of other states are also providing backing, or "credit enhancement," for charter school bonds. In **Texas**, charter schools can get their bonds fully guaranteed by the state. In **Colorado** and **Utah**, the state will provide a "moral obligation," which is not a formal guarantee, but creates an expectation that the state will likely step in if there is a default.[24] As a result, eligible charter schools get much more affordable financing. However, in these three states, the only charter schools that can get state backing are those that receive the highest, "investment grade"

[22] See NewOak, *NewOak 2017 Charter School Default Study* (2017). For Chart B, each of that 200 schools have bonds of $14 million, for a total of $2.8 billion. With state support assumes an interest rate of 4 percent, plus fees equal to 2 percent; without support, the interest rate is 8 percent. Charter schools currently getting bond financing are paying less than 8 percent. However, this does not include the vast majority of charter schools which, which when faced with the prospect of high interest rates, choose not to finance because renting is less expensive.
[23] RBC Capital Markets, Arizona Public School Enhancement Program (2016).
[24] See Building Hope, *Moral Obligation and Charter School Financing* (2017).

ratings.[25] As noted above, these charter schools can already get financing at relatively low interest rates. With state support, they get even lower interest rates. Other charter schools, the vast majority, cannot get state backing.

Based on the Arizona model, states can back charter schools that are rated BB- or better, with some funding for charter schools with a B- rating or better, whether by a ratings agency or a credible alternative, like a well-respected conduit issuer or charter school quarterback that exist in many areas.[26] In so doing, the state can back the entire cost of the building based on a reasonable enrollment projection and make sure there is at least one conduit issuer in every state and that charter school can access the bond market without unfair obstacles.[27]

States can also reduce fees for charter school financing. They can eliminate—or radically reduce—charges by conduit issuers and significantly subsidize the other fees for smaller bonds, particularly for charter schools in rural or urban areas. This will open up bond financing to huge numbers of charter schools that do not need large bonds.

2. Strengthen State Conditions for Investment in Charter School

Second, states can create strong conditions for charter school quality and investor confidence. Investors look closely at conditions in specific states. Most important is whether a charter school might have its charter revoked for arbitrary reasons. Investors expect and want tough scrutiny by a charter authorizer for academic performance. However, to address the risk of politically-motivated charter revocation by a single authorizer, they want a charter school to have options among authorizers and a fair appeals process. To address this concern, states can provide longer charter terms (e.g., 10 years, with failsafe provisions in case of poor academic performance). States can also remove caps on the number of charter schools, which unfairly limit growth and reduce bond ratings.[28]

It is helpful if states provide fair funding for charter schools. In particular, states can provide an equitable facility allotment, which increases investor confidence in repayment. States also can ensure that charter school investors get full benefit of federal tax incentives. For example, there is the new Opportunity Zone program which allows investors to reduce their capital gains tax by investing in projects—including charter schools—in economically distressed communities. This program can increase the availability of financing for charter schools and reduce interest rates. States can support Opportunity Zones, for example, by matching the incentive and accelerating the zoning and other processes by which projects become "shovel-ready."[29]

3. Provide Short-Term Loans or Grants

Finally, states can provide direct, short-term (e.g., 5 to 10 years), no- or low-interest loans for new charter schools, particularly those that are not connected with a CMO or which are in rural or urban areas. If possible, states can also provide grants to these schools which, even with state backing, are less likely to secure affordable bond financing. The state can help these charter schools by providing loans or grants until they have advanced to the point where affordable bond financing is possible.

Several states have loan programs, but they are normally small and not as focused on addressing the short-term financing needs of new charter schools. **Florida** recently established a Schools of Hope program for high-performing CMOs serving students in an attendance zone of a low-performing school. The state has put $140 million into a

[25] See Colorado Educational and Cultural Facilities Authority, Charter School Financing.
[26] See Education Cities, *Quarterback Role in Facilities Strategy* (2018).
[27] For example, in Louisiana, the State Bond Commission refuses to authorize any charter school bonds, even though there is no backing.
[28] Interview with Scott Rolfs, Ziegler (Nov. 29, 2018).
[29] Adam Peshek, *Growing Charter Schools Through Federal Opportunity Zones*, Education*Next* (2018); Interview with John Bailey, Chan Zuckerberg Initiative (Nov. 7, 2018).

revolving loan fund. There are four designated Schools of Hope operators approved thus far. Loans cannot exceed 25 percent of cost of the project.[30]

CONCLUSION

Policymakers have cost-effective tools to help charter schools secure better facilities, save money and expand options for families. The key is to help charter schools affordably access the bond market. By guaranteeing bonds, the state can dramatically reduce the cost of financing for the large majority of charter schools. State policymakers can also create conditions for charter school quality and investor confidence, reduce the fees associated with bonds and provide short-term loans for new charter schools, particularly those in urban and rural areas.

[30] See Florida Department of Education, School of Hope; Tampa Bay New, *First Florida 'Schools of Hope' Charter Company Operators Approved* (2018); Florida State Statues, Education 1001.292.

Appendix: Bond Ratings

The table below shows how S&P ratings systems work. Only bonds rated BBB- or better are considered "investment" grade. The maximum rating charter schools can get without state backing is A-.Traditional school districts typically get a AAA or AA+ rating. To get state-backing, bonds must have a minimum *underlying* rating, i.e., the rating the bond would have received without state backing.[31]

Standard and Poor's Rating System	
Ratings	
AAA	Typical rating for traditional school districts; state-backed bonds for charter schools get AAA in Texas
AA+	
AA	
AA-	Ratings for state-backed bonds in Utah
A+	
A	Ratings for state-backed bonds in Colorado
A-	S&P's highest rating possible for charter schools; rating for state-backed bonds in Arizona
BBB+	
BBB+	
BBB-	Minimum "investment" grade; minimum *underlying* rating required for state backing in Colorado, Texas and Utah
BB+	
BB	
BB-	**BEST PRACTICE: Recommended minimum level for state backing;** minimum *underlying* rating needed for backing in Arizona, except 25 percent of bonds can get lower rating
B+	
B	
B-	
CCC+	
CCC	
CCC-	
CC	
C	
D	

[31] See Building Hope, *Moral Obligation and Charter School Financing* (2017). Fitch's using the same rating system, but Moody's using a slightly different one.