

SPECIAL REPORT

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CHARTER SCHOOL TAX-FREE BONDS CAN SPELL ABOVE AVERAGE YIELDS

BACKGROUND

While the concept and beginnings of charter schools dates back to the 1992 when the first charter school opened in Minnesota, the enactment of the No Child Left Behind Act (NCLB) in 2001, signed by President Bush on January 8, 2002, has brought new insights and major changes to public education in America. The goal in establishing the NCLB was to provide a quality academic opportunity so that all students can become proficient in reading and math to at least grade level in an effort to close the gap between disadvantaged and minority students and their peers. This federal mandate is likely the reason that, today, there are 4,046 charter schools in 40 states and the District of Columbia providing education to more than 1.14 million children. The number of charter schools grew 11% over last year and growth is expected to continue.

Charter Schools are independent public schools, which are privately operated yet publicly financed. A charter school is established under a contract with the state body authorized to administer education such as a school district, state

education department or a university. The premise under which most charter schools are created is one of overcrowding or underperformance in the existing public school, thereby providing parents an alternative form of education. Education programs vary from traditional schools as they are not restricted by regulation and curricula can be tailored to the needs of the students and albeit meeting specific academic goals. A charter may be revoked and the school forced to close if either the academic standard is not achieved or financial problems arise through the lack or decline in enrollment. Unlike traditional schools operated through school districts, charter schools have no taxing power and depend on their ability to attract and retain students. There is no other funding made available for capital needs and most are charter schools prohibited from charging tuition.

States establish their own statutory framework for creating, maintaining and financing charter schools. The statute serves as the legal foundation for both the creation and renewal and/or revocation process. The revocation process may entail the right to appeal a non-renewal, with the entire procedure clearly spelled out to avoid political controversy. Typically a city or state-appointed board, or a local school district grants the charter. The authority granting the charter should maintain a formal level of financial and facilities planning oversight. Since charter schools compete for the same students with traditional schools operated by a school district, the role of the school district as charter authorizer must be impartial or, better yet, supportive of the charter school in relieving overcrowding or providing a unique curriculum specific to student's needs.

PAST AND FUTURE CHALLENGES

Funding for charter schools is derived from each state and is awarded on a per-pupil basis generally the same as traditional public schools. Financial problems have been known to arise as charter schools are dependent on allocations based on enrollment and have no ability to raise cash on their own. Beginning in 2002, federal funds were made available to a number of charter schools under the federal Credit Enhancement for Charter School program. In addition, the State Charter School Facility Incentive Grants

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Program, which began in 2004 requires matching state funds. States that currently demonstrate the strongest support for charters are Arizona, California, Colorado, Florida, Michigan, Minnesota, Ohio, Texas and Wisconsin. Charter authorization legislation in these states is more favorable than other states when it comes to funding pupil education costs close to public school student levels, providing funding for facilities as well as education & operational costs and providing an appeals process for a non-renewed charter. Additionally, charters may be granted for as long as 15-30 years before requiring reauthorization.

As of the 2006-07 school year, California had the largest number of charters with 621 and a total of 220,000 enrollees. Florida has the next highest number of charters with 355 and nearly 99,000 enrollees and Arizona follows closely behind with 355 charters and a little over 93,000 pupils. Ohio holds the fourth highest number of charters with 310 and 76,500 pupils and Texas is fifth with 242 charters and 89,000 students. The numbers are impressive but, in no way, reflect the ease of obtaining funding or the fact that a state may have always been supportive of their roles in providing an education alternative.

An example of a strong charter state is Michigan, a state with 230 charters currently and a 100,000 enrollment, its charter schools are funded directly from the state, not by a local district, and the per-pupil payments are based on a statewide allowance. Colorado, with 133 charters and 52,000 enrollees, has a state moral obligation program backing its selected charter schools. The schools must apply for the program and receive an investment grade rating prior to the sale of municipal bonds but the program has been so popular that the state is considering increasing the amounts available for bonds in the program. So far, the state has not had to back any of its participating schools. Arizona allows charter schools to pool resources to issue debt, helping them to achieve investment grade ratings. California increased state aid to charter schools through the 2006 voter approved passage of Proposition 1D that provided an additional \$500 million to the charter schools facilities program which allows charter schools to access state facility funding directly or through the school district where it is located. This legislation increased the \$400 million provided since 2002.

Unfortunately, the road for charter schools was not easily traveled. It was not until year 2005 before many states began to approve alternative education programs and the funding necessary to keep them alive. Historically charter

schools did not have enough money for operations and facilities forcing them to depend upon local businessmen and philanthropists to come up with ways to fund buildings and programs. In 2004, with the help of the Walton Family Foundation and the Bill and Melissa Gates Foundation, a study was conducted by the Thomas B. Fordham Institute to determine how public charter schools were funded, state by state and how their revenues compared to those received by district-run schools. The study examined 27 districts located in 16 states and the District of Columbia reviewing funding measures for the school year 2002-03. The study found that charter schools were under-funded by amounts ranging from \$1,000-\$5,000 per pupil vs. district-run public schools.

The analytical team performing the study characterized funding into four groups. Two states, Minnesota and New Mexico fell into the most favorable group, where revenues provided to charter and district-run schools were nearly the same. Four states, Florida, Michigan, North Carolina and Texas fell into the second group that favored traditional district-run schools by 5 to 15% more funding. In the next group, five states, Arizona, Colorado, Illinois, New York, and the District of Columbia achieved funding gaps that ranged from above 15% to 25%. And the last group, which included California, Georgia, Missouri, Ohio, South Carolina and Wisconsin, granted district-run schools over 25% more funding than their charter counterparts.

The disparity in funding became evident in 2005 (based on test scores from 2003) as a number of children in charter schools throughout the nation failed to make adequate yearly progress under the No Child Left Behind Act. Ohio was an example of that with students of certain charter schools unable to meet proficiency tests in math and english. Proponents of charter schools argued the test did not measure progress over time and many students enter charter schools after struggling in traditional schools, therefore starting out a lower level of proficiency. In 2006, Ohio's leaders began to look more closely into what could be done to improve the quality of education in charter schools. In another study underwritten by the Bill and Melissa Gates Foundation, the Thomas B. Fordham Foundation performed a policy analysis to strengthen the quality of Ohio charter schools. Recommendations were made to help meet goals including the (1) implementation of a performance based sponsor evaluation system, (2) removal of state caps on the number of charter schools permitted to open and where, (3) requirement that schools be accountable for

results and close down under-performing ones while maintaining autonomy and (4) fund charters fairly. Fairly funding charters meant establishing a Charter School Facilities Foundation to receive a proportional share of future capital bonds, remove the 15-year borrowing term limitation and allow funding through the sale of bonds via conduit issuers. Since 2005, many more states have passed measures that have advanced either state aid or the ability to obtain their own financing through the sale of tax-exempt municipal bonds.

MUNICIPAL BONDS AND RATING CRITERIA

Many charter schools now issue municipal bonds to fund facilities and several are rated by one of the three municipal bond rating agencies Moody's, Standard & Poor's (S&P) and Fitch. Each has outlined their methodology for assigning ratings but they are essentially the same. They take into consideration the (1) market position; (2) governance and management; (3) financial position and performance; (4) legal framework and covenants; and (5) the charter and state and local specific credit factors. Brief explanations of the features considered are as follows:

Market

Enrollment trends have a direct correlation to financial viability. There should be a comfortable spread between debt service requirements and revenue in the event that enrollment fluctuates. Schools with average enrollments of 1,000 students or more tend to weather fluctuations better since the impact on revenues is less pronounced vs. debt service. Greater stability of student enrollment exists in areas where there are no other schools nearby or when the traditional school is considered sub-standard.

Governance

A strong, independent board of directors is needed to provide critical oversight. Management may consist of the individual who initiated the charter or a professional management company. Neither of these alternatives is considered better than the other, as long as members remain involved and focused on a variety of issues including financial ones. A transition plan should be well defined in the event of the loss of a key individual or an entire management company.

Financial

Historical and projected financial performance is analyzed to assess performance vs. debt coverage, financial reserves and balance sheet flexibility, the degree of leverage and overall budgeting along with the school's ability to react quickly to shifting projections.

Legal

A legal bond structure that supports debt payment such as a debt service reserve fund, test requirements for issuing additional debt, collateral or security and covenants that force management to control expenditures.

Charter

A cooperative relationship between the charter school and the charter initiator (a school district, state government or a university) and the oversight provided is a key to success. Also, clearly defined criteria for charter renewal with a framework for an appeal process for non-renewals are important. Political support on the state and local level is highly regarded in the rating process as well.

According to S&P, among the 43 charter schools they rate, 10 are in the speculative grade category with the quality of all rated issues in the sector averaging below most other municipal debt, although still in the investment-grade category. Those with speculative ratings are usually underwriting expansion or fill-up risk adding an element of uncertainty in attracting new students. With the exception of one, all S&P rated charter schools carry a stable rating outlook since most represent established, successful schools with comfortable debt service coverage and little need for additional debt. The median investment grade charter school has good liquidity at 61 days cash-on-hand and debt service representing 15% of expenditures on a debt amount of \$9.3 million.

The median enrollment of an investment grade charter is 740 in contrast to the average size nationally of 256 students. Most investment grade charter schools have good student demand, with a median wait list of 311 students. The projected percent of debt service to revenues has ranged 5%-14%. Of the total number of schools that have opened, only 11% have shut down. To avoid risk, most charter schools lease their school facility at the start and many end up purchasing the facility they have been leasing. Other risk factors include a specialized school curriculum such as performing arts, situations where schools want to add grade levels or the mere fact that a school is new and has not yet been in operation with a track record.

THE FUTURE LOOKS BRIGHTER FOR CHARTERS

January 2007 marked the fifth anniversary of the No Child Left Behind Act, which requires reauthorization. However, before Congress will reauthorize it, the law must be improved to make it more workable and responsive to the real needs of children. Detailed recommendations have been made by organizations such as the National Education Association and the National Alliance for Public Charter Schools. Based on some of these recommendations, the U.S. Department of Education is designing an approach to provide tools to schools and educators to help American students achieve grade level reading and mathematics by 2014. The policy is called Building on Results and has five priorities including empowering parents, who would otherwise have to send their children to under-achieving schools, with new options to attend better schools. The addition of more charter schools was specifically cited and opens the door to funding this alternative means of providing a high-quality education.

An article in a May 2007 edition of the Wall Street Journal, headlined Students Show Scant Gains In History, Civics Knowledge, cited that the number of students who are proficient in subjects has changed little in recent years according to 2006 nationwide tests given to fourth, sixth and 12th graders. However, more students have a basic understanding of U.S. history and civics than in 2001 for history and in 1998 for civics. Important to note is that the article mentioned that “lower-performing students posted the biggest gains”. This is the argument that has been given by charter school proponents regarding the performance of charter school students and the fact those students started at a lower performance level and any advancement is to be considered positive in the momentum of a charter school providing a better education than traditional schools to disadvantaged and minority children.

News articles feature more stories about charter schools than ever before. Some articles characterize charters in a positive light, while others portray them as ill-spent money, mostly by those convinced that charters drain resources from traditional schools. In May 2007, the Los Angeles Times ran LAUSD Counters Charter Takeover Bid detailing how Green Dot Public Schools (a charter organization) proposed a takeover of one of Los Angeles' most troubled high schools (the low-performing Locke High School) with the idea of turning it into 10 small charter schools beginning in 2008. In January 2007, New Jersey's Star-Ledger featured the article State Renews 12 Charter Schools describing that the New Jersey Department of Education granted five-year renewals for 12 charter schools across the state and authorized four of those to increase enrollment. In August 2006, the Wall Street Journal reported Charting A New Course (New Orleans Schools Chart A New Course After Katrina) citing the fact that after Katrina, every New Orleans public school shut down and many would not reopen in the fall of 2006. Ten charters out of 44 that applied opened in their stead. Many in New Orleans saw charter schools as a once in a lifetime chance to remake the public education system and eke some good out of Katrina.

The rating agencies and state officials have made it clear the sector is poised for growth and GMS wants to provide its clients with opportunities to invest in products where the markets appear to be broadening. For every rated charter school bond issue, there are non-rated, higher yielding tax-exempt bonds available, an area where The GMS Group, has a niche through experienced analysis. Whether an individual is a “AAA” insured buyer or a high yield investor GMS can offer a variety of investment ideas commensurate with one's tolerance risk. Ask your broker about the current availability of charter school bonds and other special reports.



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