CHARTER SCHOOL FACILITIES

A STRATEGIC UPDATE FOR CHARTER SCHOOL LEADERS AND BOARD MEMBERS

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INTRODUCTION

If your charter school is looking to finance, refinance, build, remodel or expand school facilities over the next 10 years, we invite you to read and share this strategic update with your board members and leadership team.

Many of the "rule of thumb" norms for facilities planning over the past decade for charter schools are no longer applicable and may actually create risks that schools cannot responsibly bear.

We authored this paper in response to questions that we have fielded from charter school leaders and board members to help you avoid some serious mistakes.

This paper is part of a series that will be released semi-annually in the fall with a winter/spring update to coincide with your school's budgeting/planning cycle.

Our goal is that this paper will help you, your leadership team and board understand and successfully navigate this issue.

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WHAT HAS CHANGED?

Major increase in the cost of capital

Bond rates have nearly doubled since January. For more than a decade, charter schools have relied heavily on low-cost tax-exempt bonds to finance their facilities. What this means: if a charter school had an opportunity to close on a bond with an annual payment of $500,000 in 2022, the same building could now cost the school closer to $1 million.

Access to financing capital

With the economic uncertainty of the financial markets, the risk is significantly increasing that tax-exempt bonds will no longer be as readily available to charter schools. We are already seeing more bond investors that are not financing any more charter school deals or financing only the best schools already in the bond process. Even when financing is provided, it may be on less favorable terms than previously provided and could hamper future growth or add potential undue hardship on the schools. Lenders are now trying to control future debt and could potentially control or adversely impact the school's growth and funding plans.

Elevated cost of construction

Supply chain problems, inflation and access to construction labor has driven up costs significantly. Schools built between 2000-2010 could be built for $150-$175 per square foot excluding cost of land and schools built between 2011 and 2019 around $250-$285 per square foot. Schools under construction today are seeing costs upwards of $350-$385 per square foot. Of course the actual construction cost per square foot may vary by region but, relatively speaking, the overall percent of increased costs are fairly consistent.

Increase in land costs

Choosing the right location in the community for a charter school facility is a major factor that can contribute to the charter school meeting its enrollment and budget. However, often these desirable locations are not the lowest cost property options. In many high economic growth areas, land prices have nearly doubled. What used to be $500,000 per acre a decade ago is approaching $1 million per acre, and in hotter urban markets, as much as $2 million to $4 million per acre. Charter schools are also competing with other property buyers. Property cost is becoming a larger percentage of the overall development cost which puts pressure on the dollars a school can spend on the buildings.

Long lead times to complete development

There was a time where a charter school board could make the decision to build a new facility over the summer and have a new facility ready for the next school year. Today, a charter school board needs to make their decision to start the development process three years in advance of the school opening or longer. There are several reasons for this increase:

- Property and land searches are taking longer in many markets because of a lack of viable properties for a school and competition with other land buyers. What used to take a few months is taking a lot longer.
- Zoning, permitting, environmental studies and regulatory approvals are taking 2-3 times longer than before.
- Securing the right qualified team including architects, general contractors, subcontractors, and project managers is taking a lot longer. They are often at capacity and are able to pick and choose projects and negotiate rates and conditions to their benefit. What used to take weeks is taking months.
- Securing the right financing is taking a lot longer – months instead of weeks.

- Some construction materials have a 12+ month backorder delay.
- Thin construction labor due to demand and health issues have slowed timelines further.
- General contractors and project managers are shifting more responsibility and potential liability back onto the school. This significant shift to limit their risk and potential liability makes any project more risky and costly to the school.

RECOMMENDATIONS AND CONSIDERATIONS

Start your planning process earlier

- If your charter school has any possibility within the next five years of needing a new facility, remodeling or expanding an existing facility and/or have a refinancing event, your leadership team and board should be actively planning now.
- If you need a facility and/or financing solution within the next two years, you are probably too late and should figure out how to put a temporary solution in place for three years while you begin your facility planning process.

Assemble the right combination of partners from the start

- The first key step in the planning process is to meet internally as a board to determine what facility, remodel or expansion you envision. You need to ask questions such as: "How does this move us towards accomplishing the objectives outlined in our strategic plan?" "How quickly do we want to grow?" "What is our enrollment growth plan?" "What type of facility needs are essential to successful implementation of our educational program?" "In what ways will this new facility, remodel, or expansion impact/support our community?"
- With those parameters in mind, next meet with your finance officer or business manager to determine what you can actually afford including any school program budget changes needed to make more room for facilities cost. Be realistic and practical about aligning your facility expectations with your school's operating budget.
- Engage a developer from the beginning who has sufficient experience and internal capital to get the groundwork done with your school. Costs and timeframes are the enemy. A good development partner should right-size the facility and finance solution to be affordable for the school and manage the timeframe.
- Your school should consult with legal counsel prior to signing project-related legal agreements. That allows your counsel to advise your team on which items to pre-negotiate to establish an informed engagement and a partnership-type relationship between parties. With expert and experienced counsel working for the school, the school can know what the deal and facility size may look like, understand the expectations of the school throughout the process, and alternative partners that may be a better fit for the school that can be considered ahead of signing any documentation. This ultimately will ensure a smoother transaction and save valuable time and money.

Watch out for potential pitfalls

- Do not start with a land search. The reason is simple. Too much time can be wasted by getting your team, board and parents excited about a particular property that turns out not to be affordable and/or will not meet the timeframe.
- Do not start with an architect. There is no point in engaging an architect before feasible land has been identified. They are not in a position to cost manage or forecast construction costs.
- Do not start with a general contractor. In today's environment, general contractors are taking less cost risk than ever before and shifting more of the completion risk and cost risk to the charter school and/or developer. This means they have less incentive to be precise on their estimate of the project costs.

Make more room in your operating budget for facilities

- The old rule of thumb was that charter schools could allocate 15% of their operating revenues to facilities – and lower if they had discounted or free land and/or buildings.
- Today, charter schools should be prepared to allocate up to 20% of their operating revenues to facilities. There are facilities decisions that could lower this number. However, with the downside of facilities design and delivery timeframe, the 20% number will ensure that the school has sufficient resources to not only support contingencies but also a higher debt service coverage ratio (DSCR).
- A typical DSCR requirement used to be 1.15x but now with more market uncertainty, lenders may require 1.2x or above. DSCR measures the amount of surplus cash flow the school has before paying its debt service, such as facilities financing and/or other borrowing costs. In short, if a school has an annual debt payment of $1 million – the surplus cash flow after operating expenses (before debt service payments) would have to be $1.2 million.

Be prepared for smaller and more optimized facilities

- Smaller and more efficient space utilization can offset some of the increase in per square foot construction costs as well as property purchase costs.
- In the past decade, it was common to see 75-85 square feet of space per student. Today, you may need to consider 65 square feet and the reduction of common areas, gyms and other specialty features.
- You may need to consider phasing the buildout of your desired facilities – which will require careful planning whether you choose bond or other forms of financing.

Be open to different types of financing and financing costs

- After the Great Recession in 2009, bond financing costs were only incrementally lower than other forms of private or lease financing. At that time, bond financing was much more selective and backed only seasoned charter schools with operating track records and financials. As bond prices have already increased significantly, other forms of financing may need to be considered.
- Non-bond debt financing or long-term lease structures could provide more flexibility for charter schools to phase build, provide financing for newer charter schools, and still provide options for charter schools to refinance at certain points if lower-cost financing becomes available (i.e., bond market pricing becomes more competitive).
- It is important to note that whatever financing option a charter school chooses to use should NOT put the interest rate risk and/or the refinancing risk on the school. Interest rate risk is a risk that, if interest rates significantly increase, the charter school will have to pay a higher interest rate because the term of the initial loan is shorter (e.g. < 10 years) than the life of the asset and therefore needs to be refinanced at a higher rate. A refinancing risk is a risk that, when a charter school is required to refinance at the end of a term (e.g. 5-7 years), it is subject to a penalty or default if there are no financing options available at that

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In the next strategic update:

- We will provide updates around the future outlook and recommendations – especially about the status of financing sources.
- Discussion about roles and responsibilities of school leadership, board of directors and partners in the real estate development process.
- Discussion about who should be absorbing or sharing risks – especially completion, construction cost and timeframes.

ABOUT THE AUTHORS

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For over two decades, Ted has worked to help the charter movement grow in a healthy, sustainable and scalable way. He led the strategic planning process and business plan development for many of the founding charter management organizations and state associations. He supported over 16 state associations in their founding years to build their capacity to aid their charter schools with quality, effectiveness and growth–backed by the major foundations. Early in the movement, he was instrumental in launching and supporting insurance programs and facilities finance sources that impacted thousands of charter schools and representing billions of dollars in financings. His driving question for the charter movement is: How can we do better to deliver on the promise that charter schools made at the beginning of the movement for innovation and superior performance?

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Attorney Joseph E. "Joe" Hoffer leads the Firm's Texas and national charter school practice. Joe has represented more than 700 charter schools in Texas for his entire legal career. Admitted to Texas Bar in 2006, he is also admitted to practice before the Fifth Circuit Court of Appeals, U.S. District Court, Western District of Texas and U.S. District Court, Northern District of Texas and U.S. District Court, Southern District of Texas. Joe is a nationally recognized speaker on federal procurement laws with emphasis on fraud and whistleblower laws and issues impacting public entities. He also regularly presents on nonprofit 501(c)(3) and corporate governance issues. Joe's practice focuses on the representation of Texas public entities in all areas, including civil litigation, financial transactions operations, construction, governance, nonprofit tax law, construction litigation, administrative law and litigation, employment, student law and civil rights matters. He has also been recognized as a Best Lawyer in the legal field by the Scene in SA magazine and a Rising Star by Texas Super Lawyers for multiple years.

TINA SMITH

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VP of Portfolio Management,
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Tina has over a decade of direct charter school experience including firsthand knowledge about the struggle for a charter school to make wise facilities decisions. She is a former educator, founding team member and board chair of a successful charter school, and previously the Chief Operations Officer at the Utah Association of Public Charter Schools. Tina's Portfolio Management team analyzes key data points to assess the academic, financial, operational and governance capacity and risk of Highmark's projects. Tina and her staff also monitored the performance, stability and compliance of a large charter school bond portfolio. In this role, they interacted closely with school boards, school leadership and charter authorizers. She works to help charter schools create sustainable processes and systems that drive school and student success. Tina has provided governance training, technical assistance and mentoring for new and existing board members and administrators and has presented at numerous charter school conferences.

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Widely regarded as an expert on charter school finance, Raj has presented numerous workshops on financial best practices across the country. CSBM provides accounting, payroll, budgeting, financial reporting, forecasting and audit preparation services to more than 150 charter schools and CMOs in 10 states. Raj was named NYS's Small Business Person of the Year by the US SBA. CSBM was named Small Business of the Year for Eastern Region of the US by the US Chamber of Commerce three times. As a Minority Business Enterprise, Certified B Corp and Benefit Corporation, CSBM was awarded Best for the World by B Lab multiple times, as well as one of the Best Places to Work by Crain's NY Business. Raj teaches Understanding Social Enterprise: How to Use Business as a Force for Good as an Adjunct Professor at NYU's Wagner School of Public Service.