

# Charter School Facility Finance

## A Resource for Boards and Administrators

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**Neil Walter, CFA, MBA**

direct 435 627 5720  
office 435 628 1609  
nwalter@naiaexcel.com

**In affiliation with**



Funding facilities is one of the most challenging problems faced by boards and administrators of new or growing charter schools. Experienced real estate attorneys, CPAs, and other professionals serving on boards can be frustrated by developer lease negotiations and bonding. Founding boards with capable and qualified school directors and business managers can be intimidated by the challenge of delivering a facility on time and ready for school to open. Charter management organizations and multiple campus schools are looking to drive financing costs down. The information provided on charter school facility finance gives boards and administrators the framework they need to improve decision making in their school.

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## Introduction

Vista School of Performing Arts and Technology was in its third year when the Board Chair asked if I would run for a board seat. As planned, in the first board meeting the Board Chair assigned me to lead the effort of acquiring the school facility from our developer.

I spent three months talking to commercial real estate lenders, mortgage brokers, and underwriters. I consulted at length with our school's financial advisor and attorney. I checked references, read our lease agreement, audits, and appraisal.

Financing our school was fraught with setbacks. Initially, I tried to fund the school with a USDA loan. We failed to meet USDA guidelines, then we failed to secure a traditional commercial real estate loan, then we failed to generate enough interest in a bank private placement issue. Our last option was a bond issue.

Our school had reservations about going through the bonding process. We had a great outcome, but it was six months of work. I negotiated with the underwriters, the title company, the attorneys, the developer, the developer's lenders, the adjacent property owners, the city, the credit rating agency, and anyone else who would listen. Although our attorney and the underwriter put together the offering statement, I worked closely with the school to prepare all of the supporting documentation in an effort to represent the school in the best possible way. I personally met with investors considering purchasing school bonds and went on facility tours with them.

Finally, I read everything. Hundreds of pages. If something wasn't right, I pointed it out. If I didn't understand, I asked questions. If I disagreed, I negotiated.

The following March, the underwriter sold the issue and raised the money in an hour. In fact, the issue was oversold, which allowed us to get slightly better terms than anticipated. When compared with our lease agreement, the bonds saved an average of \$580,000 per year over 23 years. Even better, we owned the building, so there was no need to renegotiate at the end of the lease. We were even able to purchase an additional 2.5 acres of land for a playground expansion.

What did I learn? Asking questions is good. Timing matters. Don't be afraid to negotiate. Flexibility is valuable. Developers play an important role, but schools need options. After teachers and staff, facility finance is the largest single budget line item at roughly 20% of revenue. Most schools can save money if they get the facility decisions right early on.

Since Vista's bond closing, I have spoken to hundreds of other people about charter school finance to better understand the changing landscape. I hope the information provided here helps other charter schools save money.

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## Facilities Decisions and Getting Started

In all facilities decisions, it is important to know what the objective is. To minimize cost? To support a particular curriculum or educational experience? A combination of the two? To open as quickly as possible? Something totally different?

Nearly everyone in academics wants to see additional money flow into schools. Asking state legislatures to appropriate more funds is one solution. Finding ways to increase discretionary funds already allocated to the schools is another.

No matter the facility decisions a charter school makes, with hindsight there will always be something else the school could have done that would have saved money. Looking ahead, there will always be someone telling the administration and board that they can save the school money if they change something new. It is the responsibility of the board and administration to make the best decisions possible on behalf of the school and move forward.

Grading school facility decisions as right or wrong should be considered in the context of school objectives, not absolutes. Hopefully, understanding the facility finance process from start to finish will give charter school administrators and boards the information and perspective they need to make the best facility finance decisions for their school.

### **Charter Applications**

Before a school needs a facility, the school must successfully complete the charter application process. Charter school authorizers require prospective schools to plan for success by writing a charter and completing an application process. While prospective schools know they need a facility, many fail to appreciate the significance of the facility decisions they make at this point in the process.

### **Budget First or Facility First?**

The funds a school allocates in its projected budget become the first constraint governing what kind of facility a school can have. If a school knows what kind of a facility it wants, it is important to determine if the facility can be built, acquired, or leased for the amount budgeted. The converse is also true. If the school board knows its budget for facilities, it can determine what kind of building the school can afford. If a school board doesn't know one or the other, it still has work to do.

Some make the mistake of misaligning their facility wants and their budgeted funds. This can happen by misreading the facility options in the market, underestimating the cost of building or renovating a facility, not understanding impact fees and site preparation costs, or being overly optimistic about access to inexpensive capital. No matter the reason, underestimating facility costs may directly impact more important resources such as the school's teachers, staff, curriculum, and equipment.

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## **Developing a School Budget**

In preparing a budget for the school, the annual facility lease or debt service expenditure is an important line item, but so are property taxes (where applicable), insurance, utilities, and maintenance.

A good recommendation for those writing charter applications today is to write the application with long term permanent financing in mind. Start operating the school in the first year in compliance with the covenants that are typical for the permanent financing the school hopes to qualify for. Regardless of whether the school expects to use bank financing, private capital, or bond markets, knowing what the lender requires will help the school qualify for permanent financing when that time comes.

This exercise requires calculating not only the anticipated lease payment or initial debt service, but also the projected debt service, the projected debt service coverage ratio, the projected capital investment needs of the school, the school cash flow, and the days' cash on hand.

A sample five-year pro forma budget complete with the relevant metrics is provided in Exhibit A.

### **Why So Much Work on Budgets during the Application Process?**

Because the debt service coverage ratio, maximum annual debt service, and days cash on hand metrics will impact the interest rate and ability to get a loan, schools should start with a focus on them. These metrics will impact school budgets for the life of the school.

Lease costs will be less expensive for financially strong schools than for new or speculative credit schools. Interest rates will be lower for financially strong schools. Origination costs and other fees will be lower for financially strong schools. If a school wants to control facilities costs five, ten, or fifteen years from now, it should start before the school signs its first letter of intent for a facility. Once the school has made a commitment, it is very difficult to change course—particularly if the school is making capital improvements to the space or there are long term financial commitments related to the facility.

Making decisions in the context of school objectives and having the perspective of recognizing needs and opportunities in the future will significantly help schools improve facility decision making processes. The very first facility decisions made by a school will likely impact all other facility finance decisions.

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## Leasing Existing Space

Many charter schools choose to lease existing retail, office, or industrial space for their school. Sometimes they may even lease a facility that was once used as a school in the past. Understanding the basics of commercial leasing will help improve outcomes for schools considering this option. Schools should consider lease rate, lease escalations, renewal options, and other related lease costs.

One school decided not to work with a developer because they felt the lease terms associated with the developer were too expensive. They chose to lease existing flex space in their city and retrofit the space for their needs. While they thought they saved money, the truth is the lease escalations and the structure of the lease options forced the school to spend tenant improvement money twice while paying a higher than market lease rate. This was an avoidable scenario.

### **Lease Rate**

Most decision makers tend to focus primarily on the lease rate first. Is the lease rate consistent with other similar properties in the market? This is usually an easy question to answer. Sometimes the landlord doesn't care what other properties lease for, particularly if they feel like the school must have their facility.

Comparing equivalent lease rates is not always as simple as it appears. Quoted lease rates may include free rent, which makes the effective lease rate is lower than what is quoted. In addition, lease rates may be inclusive of or specifically exclude things like property taxes, insurance, building maintenance, landscaping, property management, water, natural gas, electricity, internet, janitorial, and common area maintenance. A full service lease where the landlord includes all of these costs in the lease rate is not equivalent to a triple net lease where the tenant is directly responsible for all of the costs.

To illustrate one example, in some states, property taxes are only exempt if the school owns the facility. In other states, property taxes are exempt if the school owns or leases the facility. What should the school do if it is leasing a part of a facility and the owner is paying the property taxes as part of the lease? Even if the school is exempt, because of the way the property taxes are being assessed and paid, the school could end up paying property taxes anyway.

Asking the landlord to make improvements specific to the school is a common request by schools, and it is a common concession by landlords. When comparing two spaces for lease, try as much as possible to compare costs after accounting for tenant improvement requests. If a school needs significant tenant improvements, the landlord may agree to provide them, but the landlord may also ask for a higher lease rate to compensate for the additional money that must be invested into the property. At first glance, one space may appear less expensive than another but may ultimately cost more after accounting for tenant improvement expenses. The

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least expensive space at face value could end up being the most expensive for the school.

When comparing lease rates, it is important to adjust for free rent, different expense structures, and tenant improvements.

### Lease Escalations

Anytime a school leases space, it should not only calculate the lease rate in the first year, but calculate the lease rate for each year of the lease. This seems like obvious advice, but there are compounding effects from a lease that escalates at 2% per year versus 3% per year versus 10% every five years. Some leases have fixed steps that may have exceptionally high lease rate escalations. Further, it is very common to index lease rates to the United States Bureau of Labor Statistics Consumer Price Index or CPI.

The CPI has averaged 2.4% over the past 20 years. During the 1980's it was much higher. Recently, it has been relatively low because of the lack of inflation since the Great Recession. With the CPI, a school's lease rate increase will mirror the government's estimate of inflation. It is important to note that some economists believe that the CPI overstates inflation by as much as 1% per year. More information on the CPI can be found here: <http://www.bls.gov/cpi/>

The difference between 2% and 3% escalations ten years from now is a 10% higher lease rate. The ideal scenario is to have a level lease rate where there are no escalations, but most landlords will not agree to a level term lease.

For comparison, following is an example of some lease scenarios compounded with 10 years of escalations. The lease structure can result in substantially different lease costs in the future.

Year	CPI
1995	2.8%
1996	3.0%
1997	2.3%
1998	1.6%
1999	2.2%
2000	3.4%
2001	2.8%
2002	1.6%
2003	2.3%
2004	2.7%
2005	3.4%
2006	3.2%
2007	2.8%
2008	3.8%
2009	-0.4%
2010	1.6%
2011	3.2%
2012	2.1%
2013	1.5%
2014	1.6%
<b>Average last 20 Yrs</b>	<b>2.4%</b>

	<b>Base Rate \$ 100,000</b>					
	Level Lease	2% Annual	3% Annual	10% every	\$10,000 Every	
Year	Payments	Increases	Increases	5 Years	Third Year	
1	\$ 100,000	100,000	100,000	\$ 100,000	\$ 100,000	\$ 100,000
2	\$ 100,000	102,000	103,000	\$ 100,000	\$ 100,000	\$ 100,000
...	...	...	...	...	...	...
9	\$ 100,000	117,166	126,677	\$ 110,000	\$ 120,000	\$ 120,000
10	\$ 100,000	119,509	130,477	\$ 110,000	\$ 140,000	\$ 140,000
11	\$ 100,000	121,899	134,392	\$ 121,000	\$ 140,000	\$ 140,000
Total Payments	\$ 1,100,000	\$ 1,216,872	\$ 1,280,780	\$ 1,171,000	\$ 1,270,000	\$ 1,270,000
Average Payment	\$ 100,000	\$ 110,625	\$ 116,435	\$ 106,455	\$ 115,455	\$ 115,455
Diference from Level	\$ -	\$ 116,872	\$ 180,780	\$ 71,000	\$ 170,000	\$ 170,000

### Renewal Options

Schools that lease existing space frequently underestimate the value of renewal options. Renewal options give the school the right, but not the obligation, to remain in the space past the initial term. For example, if a school has a five-year lease with two five year options, the school has the ability to remain in the facility for 15 years—if it chooses. The school may also terminate the lease and leave at the end of years 5 or 10.

If a school opens in a non-traditional school facility with intentions of moving into a new or better facility within five years, why should the school ask for renewal options? Because, if for any reason the school needs to stay longer, and it doesn't have the right to stay, the landlord has significant negotiating leverage.

For existing facilities, why is a five-year lease with three five year options better than a 20 year lease? They are both 20 year terms. With a 20-year lease, the lease rate is set for the full 20 years. If market lease rates rise faster than the negotiated rate, then the school is better off. If market lease rates rise more slowly than the negotiated rate, then the school spends extra money unnecessarily. If the school has a five-year lease with three five-year options, at the end of each five-year period, the school can continue to lease the facility at the negotiated rate or, the school can threaten to move and renegotiate the rate. This puts the school in a stronger negotiating position to ensure lease rates are not inconsistent with market rates.

A school that enters into a five-year lease without options to renew is in a precarious position. Five years isn't very long for a school to be operating. It typically takes significant investment to establish a charter school in a location—even if the landlord is doing most of the improvements. At the end of the lease term, if the school really needs to stay and it doesn't have renewal options, the landlord is uniquely positioned to win this negotiation. An astute landlord will recognize that raising the rent will be expensive for the school—but still less expensive for the school than moving to a new location.

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Last, if there is any intention to purchase the facility, this needs to be considered carefully prior to lease execution. Once the lease has been signed, it will have a significant impact on the value of the real estate. Now that the landlord has the school as a tenant, the landlord's motivation to sell the property may change. If the school intends to purchase the building, it should negotiate the purchase option up front where the purchase price is known.

### **Other Related Lease Costs**

Rent is only one part of the cost of leasing property. In a triple net (NNN) lease, the rent does not include any of the expenses of operating the facility. In addition to the base rent, the tenant may be responsible for paying property taxes, insurance, building maintenance, landscaping, property management fees, water, natural gas, electricity, internet, janitorial, and common area maintenance. A full service lease that includes all of these costs as part of the lease rate is not equivalent to a NNN lease where the tenant is directly responsible for all of these costs.

One of the most common surprises in leasing existing facilities is common area maintenance (CAM) costs. If there are shared resources like parking, parking lot lights, landscaping, access, hallways, or entrances, then it is likely there is a charge for CAMs. Don't forget to include the CAMs in the lease analysis. Schools may be surprised to learn that CAMs can be as much as 20% of the base lease rate.

### **Abstracting the Lease and Summary**

Before the school signs the lease agreement, it should abstract the lease. This is the process of determining all of the key dates, the escalations, and the total operating costs in a summary format. If the board and administration know how the economics of the lease work, they are far less likely to be surprised five or ten years into the agreement.

Leasing doesn't have to be a bad experience. In fact, leasing is a form of 100% financing, which preserves precious startup capital for a new school. It can be a great option that in some circumstances may even be less expensive than purchasing a facility. A school that understands the lease provisions and how the facility cost to the school will change over time will make more informed decisions because of the additional effort up front.

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## Developer Build to Suit with Purchase Option

Many charter schools want to have a facility built for them. Schools who do their homework learn that it is extremely difficult to find financing for an organization with no down payment, no personal guarantors, and no operating history. Further, most schools underestimate the entitlement and project management issues related to building a new school. An experienced developer creates value by providing financing and real estate project management expertise.

### Typical Deal Structure

Most transactions follow a simple format. The school and the developer estimate the total cost of the facility, often referred to as the total project cost. The total project cost includes land, site preparation, engineering, architecture, construction costs, the developer's fee, financing costs, municipal impact fees, and any other costs incurred in the construction of the school.

The school and the developer then negotiate a letter of intent that outlines the lease rate and term based on the total project cost, the lease rate escalations and other lease costs during the lease term, and the purchase option price and purchase option window.

For illustration, assume that a school facility has a project cost of \$5,000,000. A typical build-to-suit with purchase option may be summarized as follows:

Project Cost:	\$5,000,000
Lease Rate:	\$ 500,000 (10% of the project cost)
Escalations:	2.5% per year starting in year 3
Purchase Option:	125% of the project cost <sup>1</sup>
Purchase Option Window:	Between years 3 and 5

It is common to have a discounted lease rate in the first lease year and maybe the second year. Discounted lease rates beyond year one are a concession by the developer.

If most developers are quoting similar terms, how do schools know which developer to work with?

- 1) Developers will not deliver the same project cost—even with the same contractor and site. Development fees and the way they manage the project

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<sup>1</sup> Some developers quote the purchase option as a CAP rate. For example, if the total project cost was \$5,000,000 and the lease rate was \$500,000 annually and the purchase option was a CAP rate of 8%, then the purchase option price would be  $\$500,000 / .08 = \$6,250,000$ , which is 125% of the total project cost. If the total project cost was \$5,000,000 and the lease rate was 9.5% of the project cost with a purchase option CAP rate of 8%, the lease rate would be \$475,000 per year with a purchase option of  $\$475,000 / .08 = \$5,937,500$ , which is 118.75% of the project cost.

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can impact the total project cost. Project cost will impact lease rate, purchase option, and long term financing costs. The total project cost will set in motion all of the future facility payments until the school is paid off.

- 2) Flexibility on the purchase option is a big deal. A developer who will let a school exercise the purchase option to acquire the school earlier than year three is making a concession. A five-year lockout on purchasing a school results in less flexibility and should be avoided unless there are offsetting benefits somewhere else in the transaction for the school. Flexibility in the purchase option allows a school to go to market when it is a good for the school as opposed to when it is good for the developer.
- 3) On time delivery. One of the most under-appreciated features is delivering a school on schedule. Late deliveries may result in attrition from students, additional expense, and at a minimum it can be very inconvenient.
- 4) Team approach. School boards and administration need to be able to work with the developer, even when there are difficult decisions. Prior to signing an agreement, make sure the school has confidence in the relationship. Once signed, the school will lose most of its negotiating leverage.
- 5) Check references. If a school asks the developer for references, they will get the schools the developer wants them to get. Go to the developer's website and find other schools they have built and ask them what their experience was with the developer.

School credit matters in negotiating lease and option terms. There can be a big difference between a brand new startup school and a school with an operating history and a credit rating. Those schools with investment grade credit ratings can expect substantially better terms on the developer fee embedded in the project cost, in the lease rate, in the purchase option, and in purchase option window relative to a startup school.

### **Open Book versus Closed Book**

Most developers bid the facility as an open book deal or a closed book. In a closed book deal, the school and the developer negotiate the project cost. If the developer spends less than the project cost, the benefit accrues to the developer. If the developer spends more than the project cost, the benefit accrues to the school because the project cost was fixed.

An open book deal is where the school agrees to pay a lease rate based on the project cost, but the developer shows the school all of the costs along the way and involves the school as a key decision maker in the process. If there are savings along the way, the school is the beneficiary. If there are unexpected costs, the school must decide if it wants to try and cut costs somewhere else. If the school wants to make

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changes, it is easy for the school to determine the impact on their lease rate and facility purchase price.

An open book deal has different incentives from a closed book deal. For example, a closed book deal may result in a developer choosing lower quality construction or finishes so the developer can save money and increase its profit margin. An open book deal may cause a developer to not be as vigilant about controlling costs because they will be passed directly on to the school.

In either situation, it is important for the school to have a close relationship with the developer and be able to openly communicate about issues and concerns. This is important not just while negotiating terms, but all through the development process. An adversarial relationship between the developer and the school can be very frustrating and in most instances results in higher actual project costs for the school.

### **More on Lease Escalations and Purchase Options**

Every charter school lease I have seen with a developer has lease escalations in it. Most commercial lease agreements also have lease escalations in them, so this provision is not unique or even punitive when compared with industry standards. Multinational corporations and federal, state, or local governments' leases of real property also typically have lease escalations in them.

While negotiating a long term lease with no escalations in it is not realistic, understanding the incentives of the developer and calculating the cash flow is realistic.

Developer agreements become more nuanced once the lease starts escalating. For example, some agreements will have a purchase option that does not change. Some agreements will have a purchase option that will become more affordable with time. Some agreements will have a purchase option that will increase over time. This is a very important component of the lease to understand.

Consider a 20-year lease with a lease rate of 10% of the total project cost and 3% annual escalations and an 8% CAP rate purchase option.

<b>\$5,000,000 Total Project Cost</b>		<b>\$500,000 Lease Rate</b>				
Year	Level Lease Payments	3% Annual Increases	Difference	Option @ 8% CAP	% of Project Cost	
1	\$ 500,000	416,667	(83,333)	NONE	N/A	
2	\$ 500,000	500,000	-	NONE	N/A	
3	\$ 500,000	500,000	-	6,250,000	125%	
4	\$ 500,000	515,000	15,000	6,437,500	129%	
...	...	...	...	...	...	
19	\$ 500,000	802,353	302,353	10,029,415	201%	
20	\$ 500,000	826,424	326,424	10,330,298	207%	
Total Payments		\$ 10,000,000	\$ 12,623,884	\$ 2,623,884		
Average Payment		\$ 500,000	\$ 631,194.22			

Notice that staying in the lease for 20 years results in total lease payments of \$12,623,884. Because the purchase option is structured as an 8% CAP rate, the price of acquiring the building goes up as the lease escalates. At an 8% CAP, the purchase option starts at 125% of the project cost, but then increases in each subsequent year. A transaction structured in this format is designed to incentivize the school to purchase the facility and not stay in the lease.

Below is another 20-year lease scenario with a lease rate at 10% of the total project cost and 3% annual escalations and a 125% purchase option. Note that the 125% purchase option is the exact same as the 8% CAP purchase option in the previous scenario. This lease has a five-year lockout and then the option price becomes less expensive at key intervals. This lease is designed to incentivize the school to stay in the lease.

<b>\$5,000,000 Total Project Cost</b>		<b>\$500,000 Lease Rate</b>				
Year	Level Lease Payments	3% Annual Increases	Difference	Option at 125%	% of Project Cost	
1	\$ 500,000	416,667	(83,333)	NONE	N/A	
2	\$ 500,000	500,000	-	NONE	N/A	
3	\$ 500,000	500,000	-	NONE	N/A	
4	\$ 500,000	515,000	15,000	NONE	N/A	
5	\$ 500,000	530,450	30,450	\$6,250,000	125%	
8	\$ 500,000	579,637	79,637	\$6,000,000	120%	
13	\$ 500,000	671,958	171,958	\$5,750,000	115%	
18	\$ 500,000	778,984	278,984	\$5,500,000	110%	
19	\$ 500,000	802,353	302,353	\$5,500,000	110%	
20	\$ 500,000	826,424	326,424	\$5,500,000	110%	
Total Payments		\$ 10,000,000	\$ 12,623,884	\$ 2,623,884		
Average Payment		\$ 500,000	\$ 631,194.22			

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If a school intends to purchase its facility quickly, the second lease scenario will be frustrating, and the school will wish it had executed an agreement like the first scenario. If a school needs extra time to mature before seeking financing to purchase its facility, the second lease will keep the purchase option price down, but the school should understand the lease rate will keep going up each year.

There are many variations of the two scenarios shown above, but these two frameworks illustrate the dynamics of lease cash flows.

### **Abstracting the Agreement**

Understanding the lease cash flows and purchase option are a good start to abstracting the lease agreement. A lease abstract is a summary of the key provisions of the lease. It should include the following at a minimum:

- 1) Landlord (or Lessor)
- 2) Tenant (or Lessee)
- 3) Lease Commencement Date
- 4) Rent Commencement Date (this may be different from lease commencement)
- 5) Facility Address
- 6) Facility Size
- 7) Expected Total Project Cost
- 8) Lease Rate
- 9) Date Escalations Begin
- 10) Escalation Amount
- 11) Cash Flow Projections
- 12) Purchase Option Dates
- 13) Purchase Option Amounts
- 14) Total Project Cost Price per Square Foot
- 15) Purchase Option Price per Square Foot
- 16) Penalty for Missing the Delivery Date

A sample abstract is provided in Exhibit B. The concept is simple. Put the economic terms and key dates on a single sheet of paper. If there are costs that are related to the facility like property taxes or CAMs or other direct real estate charges, they should be included also. In the example provided, property taxes paid by the school are shown as a direct expense.

Schools who discuss their lease agreements with advisors frequently think they have a different deal than what they actually have because they didn't abstract the agreement.

### **Other Considerations**

Schools should start discussing options with developers as early as possible. Most schools will not be able to contract for land, let alone acquire it without a commitment from a developer. The earlier a school starts this process and the

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better they understand the dynamics, the better position they will be in to ensure the school will get the best terms possible.

Sublease Agreements rarely reflect the entire agreement. If a school is working on a transaction and its representative is reviewing a sublease agreement, the sublease likely references the original lease (sometimes referred to as primary lease or master lease). The school should not only understand and abstract the sublease, but it should have a copy of and understand the master lease. Failing this critical step may result in misunderstanding key provisions of the whole agreement.

Developers like charter schools and they want to help charter schools, but schools who expect developers to deploy their capital and expertise for free (or nearly free) will be disappointed. Developers are taking risk and building facilities with the intention of making money. Every developer has a story about how they came to be in the charter school development business. Every story is interesting and compelling. While the backstory is important, don't let it distract the school's decision makers from making the best decision for the school.

### **Land Selection, Entitlement, and Land Acquisition**

Once a school has committed to a developer, it is time to contract for the land (or existing facility). Charter schools receive capital for annual operations, but they don't receive lump sum money to build or purchase a facility. Developer financing effectively is a 100% loan combined with development expertise.

The developer will work with the school to select and contract for a parcel of land for the new facility. The developer should take the lead in working through the permitting and entitlement process with the local municipality. If the administration or board members do not have significant experience with these issues, it is easy to underestimate the challenges and costs associated with the entitlement process.

Once the school and the developer are confident that the selected parcel is suitable for the school and the permitting and other work with the municipality is complete, the developer should be ready to purchase the land. After purchase, the developer will begin grading and site preparation in advance of vertical construction.

### **Vertical Construction**

After the land is acquired and the site work is complete, the foundation will be poured and vertical construction will start. This is the most visible role of the developer, but it is also the one the developer will have the most help with. The general contractor and subcontractors will be doing most of the work while the developer will be focused on keeping the project on schedule and on budget.

With a July or early August delivery date, the developer team will be focused on delivering a school prior to school starting. Failure to have the facility ready for the opening day of school and the inconveniences that go with the delay can erode

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parents' enthusiasm for the new school and potentially impact enrollment. Typically, there is also a financial penalty for the developer.

During construction, change orders are going to be expensive because they disrupt the expedited workflow occurring on the site. It is important to put as much effort as possible into providing the correct specifications prior to the start of vertical construction.

With a great partner and a bit of luck, the school should be opened on time to specification and 100% financed with a plan for permanent financing in place.

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## Negotiating a Facility Lease

Negotiating a facility lease requires an understanding of the terms and economic impacts of the two previous sections, Leasing Existing Space and Developer Build to Suit with Purchase Option. With those frameworks in place, here are some important considerations.

### **The Letter of Intent**

A letter of intent is an expression of interest to enter into a lease agreement that identifies the parties to the transaction, the property considered, and the proposed economic terms of the agreement. There is not a formal structure or a required template. It should at a minimum contain the items that were previously referenced in abstracting the lease or developer agreement.

### **Only One Option—No Negotiating Leverage**

Negotiating the best terms for a school requires investing the time to create options. Regardless of whether the application is a parcel of land to build on, an existing facility to move into, a facility yet to be built, or with developer who will build a school, having only one option is a sure way to leave money on the table.

Consider an existing facility. If a school wants to move into an existing facility and it is the only choice the school will be happy with, what can the school tell a landlord who won't provide the needed tenant improvements? How can the school make a credible threat to take another space? Simply having an alternative choice that is similar allows the school to counter a landlord's proposal with the confidence that an alternative solution is available.

Developing multiple options is critical to a successful negotiating strategy. Having alternatives gives a school the ability to say "no" in the negotiation.

### **Free Rent and Other Discounts**

Often a landlord may offer concessions in the form of free or reduced rent early in the lease to incentivize a school to enter into an agreement. These can be very valuable concessions and schools should pursue them. While negotiating or considering free rent, don't lose sight of the long term total cost of the lease. Signing a lease with attractive lease rates in year one or two may be a good choice for a school, as long as the balance of the lease payments are also affordable.

### **Common Area Maintenance (CAMs)**

Many existing facilities recover common area maintenance costs (CAMs) by charging the respective tenants or property owners for a pro-rata share of their expenses. The most common allocation method is by square feet, although there are others. Schools should ask in the very initial stage of the negotiation what the common area costs are, what they include, and who pays them.

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## **Property Taxes**

Many states now have laws that regulate when schools are required to pay property taxes. If a school is leasing, there may be a provision where the school is exempt from paying property taxes even if the school does not own the property. In some instances, the state may have a law exempting the property owner from paying property taxes, but the way the property taxes are assessed creates a situation where the school may not know they are paying property taxes or it is difficult to obtain a waiver.

Two specific situations to watch for are when property taxes are paid as part of CAMs and when the property is not subdivided. If there are property taxes charged with the common area costs, it may be difficult to receive a property tax waiver, depending on the situation. In the event a school is leasing only a portion of a property, obtaining a property tax waiver may not be as easy as for a standalone facility. Understanding these nuances is an important part of determining the monthly or annual operating cash flow for a school.

## **Tenant Improvements**

Costs incurred by the tenant or landlord to make an existing facility ready for occupancy are called tenant improvements. For an existing facility that needs improvements, the landlord or tenant will have to invest to make the facility ready for the school. With new facilities, they may be delivered as a “vanilla shell” or mostly complete, but the school or developer will have to invest additional money into the facility to make it ready for students and teachers. Collectively these investments are considered tenant improvements (even if the landlord pays). There is not a standard protocol for who pays for which improvements; they typically are negotiated with each transaction.

It is important to remember that a school making an investment in tenant improvements needs to protect its investment with a long term lease (or multiple renewals) or a purchase option for the facility. It is very frustrating to negotiate favorable lease terms, invest in a facility, and then at renewal have a landlord increase the rent or not provide the flexibility needed because the landlord knows it would be prohibitively expensive to move the school to a new location after having made the investment. In the long run, moving twice may be much more expensive than paying a little more during the lease term to have a renewal option or a purchase option for the benefit of the school.

## **Focus on the Cash Flow over the Life of the Deal**

Often, schools make the mistake of basing their decision on the cost of the first year lease rate. Schools should consider all of the following:

- 1) The cost of all of the lease payments, including escalations and renewals
- 2) The tenant improvements the school must invest to begin using the facility
- 3) The lease term and renewal options
- 4) The lease rate escalations

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- 5) Other facility costs passed on from the landlord to the tenant like CAMs or property taxes
  - 6) Utilities and maintenance costs, which are frequently higher for older facilities than for new

In many situations, the lease will permanently set the long term facility cost of the school. For example, in a developer build to suit with purchase option, the project cost and the lease rate determines the annual lease payments, which determines the purchase option price, which determines the bond payments, which becomes the facility cost for the school over 30 or more years. Once the lease payment has been set, it is nearly impossible to go back and negotiate better terms.

### **Credit Quality as a Liability or an Asset**

New schools are often frustrated with securing a new facility. New schools do not have someone who is able or willing to personally guarantee the lease or loan for a facility. They do not have cash to pay for tenant improvements to purchase a building. Last, they do not have a track record of performance. While the founding board and the administration may be confident the school will succeed, the property owner or developer will probably be risking millions of dollars on that assertion. Because of the risk to the property owner, most will want to perform due diligence on the school and the board. The untested school is a potential liability to the property owner or developer.

Existing schools with a track record still may not have substantial cash reserves or a personal guarantor, but the track record is an indication of future performance. Schools with a credit rating and particularly those with an investment grade credit rating (BBB- or better) should expect to get substantially better terms from both landlords and developers because they have demonstrated an ability to meet their obligations. Even if an existing school is opening a second facility, the track record and proven experience of the existing school should result in better lease terms for the school.

### **How much is Flexibility Worth?**

For schools with negotiated purchase options or schools who are in temporary facilities, it is hard to overstate the value of flexibility in the agreements.

Consider a school who plans to be in a temporary facility for two years and then build a new building. If everything goes as planned, the school could negotiate a short term lease with the expectation of moving into the building they are having built. What happens if the school needs to stay an extra year or two? The landlord may give the school a great deal, or the landlord may recognize the school has nowhere to go and will ask the school to pay dearly to stay in the facility. It is much better to negotiate the lease with renewal options up front so the school can stay in the facility at a known lease rate at the option of the school (not the landlord).

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If there is any chance the school may end up buying this facility, it is critical to negotiate this as part of the original lease negotiation. The longer the school is in the facility and the better the credit of the school gets, the more valuable the lease cash flows become to the property owner. Even though the school's credit is improving, which should result in better terms at lease negotiation, the inability of the school to move means the landlord has a very strong negotiating position. As a result, deciding to purchase the facility after the lease has been signed may become an expensive decision.

Understanding the scenarios the school may face in three, five, or ten years and preserving as much optionality for the school as possible in the negotiation can result in substantial cost savings when the unexpected happens.

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## Conventional Financing Terms and Expectations

Many schools begin the charter application process with the hope of obtaining bank financing for their school. It is easy to recognize that bank financing is typically cheaper than developer financing or landlord financing. Most who have pursued this course have been disappointed to learn that conventional loans are extremely difficult to secure for their school, unless the school has substantial cash resources available from other operations, private donations, or some other special arrangements.

While obtaining bank financing at startup may be extraordinarily challenging, obtaining bank financing after a couple of years of performance is much more achievable. Understanding how charter schools fit into the lending framework and understanding typical loan structures will help schools know how and when to approach conventional lenders like banks and credit unions.

### **Charter Schools don't Receive Funds for Capital Improvements**

Charter schools receive funds for ongoing operations, but they typically don't receive lump sum funds for capital improvements. Because of the lack of startup capital and the requirement from lenders for a down payment, schools either need substantial private donations or time to accumulate cash before pursuing a conventional loan. Individual schools and some states are exploring ways to increase the availability of traditional bank financing through legislation or special arrangements.

### **Takeout Financing**

Because obtaining funding for new construction is challenging, most schools look to conventional financing or bond financing after they have successfully established a track record. At this point, the school is typically purchasing a facility from a developer, purchasing a facility from a landlord, or moving from a facility they have leased into a facility they are purchasing. Because the school is "taking out" the property owner, it is sometimes referred to as "takeout" financing.

In order to pursue this financial option, a school must have the ability through a purchase option, purchase contract, or other equivalent contract. A school that has executed a long term lease will have to honor the lease obligations unless the landlord accommodates by allowing the school to sublease the facility or otherwise terminate the lease obligation. Typically, landlords leasing to schools are reluctant to break a lease without compensation.

### **Charter Schools are Special Use Properties**

Charter schools are what most lenders refer to as a special use property. Unlike an office building or a retail strip center, the charter school is built for a singular purpose and retrofitting the facility to serve a purpose other than as a school is challenging. Special use assets are a special class of commercial real estate that are

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typically more challenging to finance than comparable office, retail, or industrial properties because they are perceived as riskier by lenders.

### **Requirements for a Conventional Loan**

Obtaining a loan for a school will require meeting the loan-to-value requirement, a track record of meeting loan covenants, and potentially a personal guarantor. A typical commercial real estate loan at a bank or credit union has the following characteristics:

Loan-to-Value	60-75%
Down Payment	25-40%
Debt Service Coverage Ratio (DSCR)	1.2-1.3
Interest Rate	Set by Market Conditions
Amortization Term	20 years
Rate Adjustment	5 Years
Loan Term	10 Years
Personal Guarantee	Yes
Collateral	The School Facility
Closing Costs	1-2% of the Purchase Price
Time to Close	2-3 months

These are general terms. Some schools will have access to longer amortizations or higher loan-to-value ratios. For example, a school with a track record and an investment grade credit rating may be able to get 75-80% LTV in a non-recourse loan with a 30-year amortization.

Most conventional loans fail in underwriting because the school doesn't have money to put down, doesn't have someone who will sign the personal guarantee, and doesn't have a track record of meeting a debt service coverage ratio. If a school can address these issues, options start to become available. It is important to note that developers satisfy all three of the above issues with their lender when they bring capital, provide a track record, and personally guarantee the loan. This is why the developer can get a loan to build a new facility when the school can't.

### **Lenders Have Limited Flexibility**

Because of banking regulation, lenders have limited flexibility. Even though a lender may want to accept less cash down, lenders can't go above 80% LTV without a government program or additional collateral to make up the difference. Most lenders won't go above 75% loan-to-value regardless of the school's credit quality. Similarly, lenders may want to waive the personal guarantee, but they may not have the ability to issue a non-recourse loan.

School boards and administrators see a 30 year fixed loan backed by state funds as low risk. Lenders and their regulators see both the fixed rate loan and the 30-year loan term as risky. While the state may be the primary source of school funds and the state may have great credit, the school's ability to obtain those funds depends on

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its enrollment. Enrollment levels will fluctuate with the school's performance, making the school funding risky as well.

### **Work Aroun**

There are ways to work around traditional financing issues. For example, some schools have had success getting lenders to waive the personal guarantee. If a lender will make this concession, then a school needs a proven track record and some way to ensure the loan-to-value is in the appropriate range.

In some instances, schools have used a combination of donations and cash reserves to meet the down payment requirement. In other instances, schools have brought in other investors who lend the school the additional proceeds they need, essentially making the transaction 100% financing, but the bank loan portion is within the lender's loan-to-value requirements and the loan with all of the financing meets the debt service coverage ratio requirements.

Additional financing that is subordinate to the traditional loan is referred to as a subordinate loan. The bank or credit union will require the senior, first position loan. The subordinate lender is making a loan that can only have a claim on the collateral that is subordinate to the senior loan's claim on the collateral. This means that if the school were to default, the subordinate lender would have to pay the senior lender in full prior to obtaining control of the property. Typically, the subordinate loan has a higher interest rate than the senior loan.

In this way, the lender is able to meet the underwriting guidelines and the school still gets to purchase the facility, even if the school doesn't have the cash on hand to meet the down payment and personal guarantee requirements.

An example of this kind of loan structure is provided in Exhibit C.

If a school is trying to purchase a facility from a developer or landlord and having trouble finding investors to loan the school funds for the subordinate piece, it is worth talking to the developer or landlord about carrying the subordinate portion. While they have no obligation to do so, the higher interest rate and their familiarity with the school and the facility may be an attractive investment opportunity for them that allows the school to proceed forward with the purchase of the facility.

### **USDA and SBA Loans**

United States Small Business Administration loans would be a wonderful financing vehicle for charter schools. Unfortunately, they are only available to for-profit enterprises who are owner occupants of a facility. Because schools are non-profits, they don't meet the underwriting criteria for SBA loans.

If a school is in an area designated as rural by the USDA and at least 50% of the student population comes from rural communities as defined by the USDA, then the USDA loan product is one of the best funding options available to charter schools.

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USDA loan products can go up to 100% financing, do not require a personal guarantee, and have up to a 40-year loan amortization.

USDA loans result in some of the lowest debt service available to charter schools. Note that the USDA doesn't typically fund startup schools, so the financing is most frequently used to purchase a facility the school already occupies. In addition, USDA has limited funds and the rural designations change periodically. Interested schools should monitor the funding levels and the geographic criteria closely as they prepare to apply and go through the underwriting process.

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## Bond Financing and Public Debt Markets

Schools looking to purchase their facility are increasingly accessing bond markets to raise money for the facility acquisition. One of the most attractive components of bond financing is the ability for a school to obtain financing for 100% of the purchase price, plus the fees related to selling the bonds. Bond financing is becoming more common as investors and capital markets become increasingly familiar with charter school finance.

Hundreds of schools have received credit ratings and accessed capital markets. Many schools have successfully issued bonds multiple times and some schools have refinanced a prior issue to secure better financing terms. Financial advisors and investment banks who underwrite the bond issues are more aggressively pursuing schools in an effort to win their business. Interest rates for good schools are falling, and states are creating programs to reduce the overall financing cost associated with bond issues.

### **What are Bonds?**

Bonds are debt instruments sold as a security to investors. Instead of having one lender, like with a bank, the loan is broken into smaller pieces that can be purchased by multiple investors. This allows investors to diversify by buying smaller amounts of many schools instead of all of a single school.

In addition, there may be multiple tranches. Tranches are portions of the bond that may have different maturities interest rates, or both. For example, bonds may be issued so that a portion of the debt matures in three years, a portion matures in five years, a portion matures in ten years, a portion matures in twenty years, and a portion matures in thirty years. In this fashion, an investor can choose the amount of time they want to lend to the school.

Bonds may be interest only, interest and principal, or interest, principal and a debt service reserve. Structuring the bonds should be a service provided by a school's investment banker in consultation with the school and its advisors.

### **The Process**

Bonding is a complicated process that requires the coordination of multiple parties. One of the first decisions is choosing a financial advisor and legal counsel for the school. It is their job to explain the process, help the school navigate through the process, and advocate and negotiate for the school along the way. Much of the school's ability to successfully close a bond deal will hinge on the support and counsel of its advisors.

With the help of the school's financial advisor and legal counsel, the next decision is to determine if bonds are right for the school. The school's financial advisor and legal counsel will work with the administration and the board to identify the

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objectives and determine if bond financing is an appropriate solution. They will then help the school select the appropriate issuer and underwriter. The legal counsel, financial advisor, and underwriter will start preparing financials and the other content for the offering statement and credit rating. Next the school works with the credit rating agency to obtain a credit rating. At this point, the school should have completed all of its applications, the offering statement, and all of the related due diligence in preparation to sell the bonds. Now the school is ready to raise the money for the facility acquisition.



### **Financial Advisors**

Financial advisors were initially unregulated. Today, it is more common for states to require financial advisors to be vetted and approved in order to represent charter schools as a financial advisor.

The financial advisor's role in the bond issue is to look out for the economic interests of the school, to make sure the school understands the transaction structure, and to work through different financing scenarios with the school. The financial advisor may make recommendations about underwriters or weigh in on recommendations made by the underwriter as the school goes through the process of obtaining financing.

The best financial advisors know how to illustrate the costs and benefits of various options clearly to the school board and the administration. This may include lease versus buy analysis, estimating debt service payments and loan amortization schedules, or differentiating between the quoted interest rate and true cost of the loan expressed as an effective interest rate.

Finally, a financial advisor should help prepare the school in advance of the bond issue by walking the board and administration through the loan covenants the school will be obligated to abide by. Appropriately and accurately adjusting the historical financials as well as working with the school on the pro-forma financial statements to show how the school expects to perform relative to the bond covenants can influence the interest rate on the bonds and the school's credit rating.

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Financial advisors are not attorneys, but it is their job to advocate for the school and help the school achieve the best terms available for debt that is being issued.

### **Attorneys**

With a bond issue, there will be multiple attorneys involved. First, the school will have an attorney. It is the responsibility of the school's attorney to look out for the interest of the school. Everyone else will have legal counsel in the transaction, and the school should also. Having good counsel can help with both the costs associated with issuing the bonds as well as the loan terms and structure. Having counsel with experience in public finance can be a great asset to the school. An attorney who doesn't advocate for and look out for the best interest of the school or who is inexperienced can be a liability in the transaction.

Other attorneys may include underwriter's counsel, issuer's counsel, and bondholders' counsel. The underwriter's counsel may take the lead in the document preparation related to the bond issue. They represent the underwriter and are looking out for the underwriter's interest. The issuer's council represents the issuer and is making sure the bond sale is compliant with all laws and regulations related to the issuer. The issuer's council will also help ensure the transaction is structured appropriately to receive tax exempt status as well as avoid transferring unintended liability to the issuer. The bondholders' counsel represents the unnamed bondholders and is advocating for language, terms, and conditions that benefit the bondholders.

Attorneys who have been through this process have a good sense of what they can ask for and what they can't ask for. Remember, in order for the school to issue debt, all of the parties and their respective advisors must agree.

### **The Underwriter/Investment Banker**

The school hires an investment bank through an engagement letter to underwrite and sell the bonds. Underwriting is the process of putting together an offering statement that tells prospective investors about the school and about the loan the school is seeking. It also includes verifying the information and preparing the loan documents for the bonds.

In addition to underwriting, the investment bank will also solicit investors to purchase the bonds. This is done by sending out offering statements in both print and electronic formats, calling prospective investors to generate interest in the offering, and scheduling on-site visits to the school. Underwriters typically sell the bonds through an auction format that may last as little as an hour or may be open for much longer.

Because the investment banker is selling securities, they must be appropriately licensed.

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## **The Issuer**

Charter schools are typically authorized to raise money in the bond market through an issuer. The issuer can be a state, a municipality (city or county), a school district, or another entity authorized by the state to issue municipal debt. Rarely are charter schools authorized to issue debt directly. The issuer most likely will not be guaranteeing the debt that is issued. There are special circumstances like state credit enhancement programs, but most often the school is simply using the issuer's authority to issue debt on a tax exempt basis. Charter schools can issue bonds without an issuer, but they may not be recognized as a tax exempt investment and the interest rate on the bond offering will have to be higher to offset the taxable portion of the investment.

## **Bondholders**

Some people wonder who buys charter school bonds? Most issues are purchased by accredited investors. Accredited investors include institutions, high net worth individuals, investment funds, banks, and pensions. Charter schools are a form of municipal finance and those who regularly purchase bonds issued by cities, counties, school districts, and states are inclined to look at charter school bond issues as a possible investment.

The bonds are not traded, like on the stock exchange, and most issues are not available to retail investors. This means that individuals can't go to a website and buy \$5,000 of a charter school issue in the same way that one can purchase a publicly traded stock. Some financial advisors and underwriters are innovating by structuring charter school issues so that retail investors can purchase bonds in small denominations. Retail issues are the exception, not the norm today.

## **Credit Ratings**

Schools who want to access bond markets will have to choose between a rated issue and an unrated issue. Rating is the process of having a credit rating agency like Standard and Poor's, Fitch, or Moody's provide a credit rating for the school. The credit rating is an assessment of the risk of the school and its bonds.

Some schools choose to issue unrated bonds. Schools who do this save the cost of rating the school, but it also sends a buyer beware message to all investors. As expected, on average, rated schools have lower interest rates than unrated schools.

All schools that receive a credit rating are not equal. Schools that earn an investment grade credit rating (BBB- Standard and Poor's) or better will on average see better financing terms than below investment grade ratings. The ratings table below obtained from Multiple-Markets shows how credit ratings compare. Each of the credit rating agencies have additional information on their websites about their methodology and rating systems.

## Investment Grade

Color code	Number	Definition	Moody's	S & P	Fitch
		<b>Investment Grade</b>			
	10.0	Prime, maximum safety	Aaa	AAA	AAA
	9.5	Very high grade/quality	Aa1	AA+	AA+
	9.0	"	Aa2	AA	AA
	8.5	"	Aa1	AA-	AA-
	8.0	Upper medium quality	A1	A+	A+
	7.5	"	A2	A	A
	7.0	"	A3	A-	A-
	6.5	Lower medium grade	Baa1	BBB+	BBB+
	6.0	"	Baa2	BBB	BBB
	5.5	"	Baa3	BBB-	BBB-

## Speculative Grade

Color code	Number	Definition	Moody's	S & P	Fitch
		<b>Speculative grade</b>			
	5.0	Speculative	Ba1	BB+	BB+
	4.5	"	Ba2	BB	BB
	4.0	"	Ba3	BB-	BB-
	3.5	Highly speculative	B1	B+	B+
	3.0	"	B2	B	B
	2.5	"	B3	B-	B-
	2.0	Substantial risk	Caa1	CCC+	CCC+
	1.5	In poor standing	Caa2	CCC	CCC
	1.0	"	Caa3	CCC-	CCC-
	0.5	Extremely speculative	Ca	CC	CC
	0.0	Maybe in or extremely close to default	C	C+,C,C-	C+,C,C-
	0.0	Default	D	D	D

It is as important to prepare for the credit rating process as it is to prepare for the bond application with the issuer and the underwriter. Making sure school leadership is prepared to discuss the strategic direction, the financials, and the weaknesses of the school is important in the rating process.

### Par and Discounts to Par

In a bond issue, the face value of the total loan is referred to as par. In some circumstances, schools are asked or even encouraged to sell at a discount to par. Offering the school at a discount to par effectively increases the interest rate paid to the bondholders.

For example, assume the amount needed to be raised is \$10 million and the interest rate is 6%. The annual interest, using a simple interest calculation, would be \$600,000. If the school sold for a discount to par, the par value might be \$10.2 million, but the school would only receive \$10 million at funding. If the simple interest rate were 6%, the annual interest payment would be  $.06 * 10,200,000$  or \$612,000 per year. Even though in both situations the school received \$10 million to purchase their building and the face value interest rate is the same, the school selling at a discount to par is paying \$12,000 more in interest per year.

### Costs of Issuance and Debt Service Reserve

Selling bonds can be expensive. There are a number of costs that will be incurred in the process of issuing bonds. Costs will vary depending on the offering size, underwriter, issuer, and other characteristics of the offering. Some of the costs schools should expect to see with bond offerings are as follows:

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School Legal Counsel	Issuer's Legal Counsel
Bond Legal Counsel	Underwriters Legal Counsel
Trustee Fees	Financial Advisor Fee
Credit Rating Fee	Underwriter Fee
Building Inspection Fee	Title Insurance Fees

The fees can range between 3-7% of the purchase of the school. While some fees may not be negotiable, others are. Schools should always ask to negotiate every fee.

In addition to the fees above, most bond offerings have a debt service reserve fund. The debt service reserve fund represents additional funds that are borrowed to be held in reserve by a trustee in the event there were a default on the bonds. In charter school issues, the amount is typically equal to the maximum annual debt service payment during the life of the bonds. The trustee is an independent third party, often a bank, who watches over the funds and ensures that they are managed in a way that is consistent with all of the bond documents. Debt service reserves can range between 5 and 9% of the bond issue, depending on the interest rate and credit quality of the school.

It is not uncommon for costs of issuance and the debt service reserve to total 10% or more of the bond issue. Consider a school who needs \$10 million to purchase their facility. If interest rates are 6% today, then one might think the simple interest payment would be \$600,000 per year. Because of costs of issuance and the debt service reserve, the school might need to actually borrow \$11,000,000. At 6%, the simple interest is now \$660,000. Note that compared with the amount needed to purchase the school, the interest rate is 6.6%.

### **When is Bonding Better than Conventional Financing?**

Schools that don't have the ability to access conventional financing without a down payment may not have the option to choose between bonds and conventional financing. Having the proceeds to make a down payment is often the most significant determining factor. Schools that don't have funds for a down payment may not have the option to choose between bonds and conventional financing.

The second consideration is flexibility. Bonds are typically long term loans and may have prepayment penalties. Conventional loans typically have shorter maturities and are less likely to have prepayment penalties. Depending on the school's objectives, this may be a very important feature. For example, a school looking to enter into a loan for a short period of time will likely favor a conventional loan. A school looking for a long term, permanent loan will favor bonds.

A third criteria is the cost of the loan. There are many ways to look at the costs associated with borrowing money. Some look at the interest rate, some look at the costs of issuance, and some look at the annual payment. An alternative analysis is to look at the pure cash flows. Start with the amount of money needed to purchase the school and for each year calculate the total payment including all loan related costs.

Do this for each subsequent year. Then calculate any final payments at the end of the loan. Using the IRR function in Microsoft Excel or another spreadsheet program, the school can now calculate the effective cost of the loan.

In the example below, the conventional loan has a higher annual payment than the bond financing, but the bond is a more expensive loan based on the IRR.

<b>Conventional Loan (100% Financing)</b>		<b>Bond Financing (100% Financing)</b>	
Facility Cost	\$ 8,000,000	Facility Cost	\$ 8,000,000
Term (years)	10	Term (years)	10
Amortization Period (years)	20	Amortization Period (years)	30
Rate	7%	Rate	7%
All Fees	\$ 240,000	All Fees	\$ 320,000
Debt Service Reserve	\$ -	Debt Service Reserve	\$ 720,000
Total Amount Borrowed	\$ 8,240,000	Total Amount Borrowed	\$ 9,040,000
Facility Cost	\$ (8,000,000)	Facility Cost	\$ (8,000,000)
Year 1	\$ 777,798	Year 1	\$ 721,720
Year 2	\$ 777,798	Year 2	\$ 721,720
Year 3	\$ 777,798	Year 3	\$ 721,720
Year 4	\$ 777,798	Year 4	\$ 721,720
Year 5	\$ 777,798	Year 5	\$ 721,720
Year 6	\$ 777,798	Year 6	\$ 721,720
Year 7	\$ 777,798	Year 7	\$ 721,720
Year 8	\$ 777,798	Year 8	\$ 721,720
Year 9	\$ 777,798	Year 9	\$ 721,720
Year 10	\$ 777,798	Year 10	\$ 721,720
Pay of Remaining Balance	\$ 5,462,926	Pay of Remaining Balance	\$ 7,037,439
<b>Internal Rate of Return</b>	<b>7.11%</b>	<b>Internal Rate of Return</b>	<b>7.74%</b>
Total Payments (10 years)	\$ 13,240,906	Total Payments (10 years)	\$ 14,254,639

In this scenario, if a school is seeking to minimize its annual debt service, it might choose bond financing to increase its cash flow by \$55,000 per year and hire an extra faculty member. If it is seeking to minimize the total cost of the loan, it would save money by choosing the conventional loan. In fact, in this hypothetical scenario the conventional loan costs approximately \$1.14 million less than the bond financing over 10 years.

Determining which financing vehicle to choose requires evaluating school objectives in light of financing constraints. There is not a single right answer for every school. Every school must invest the time and energy to determine which alternative is best in each specific situation.

See Exhibit D to see the economics of a sample bond issue including costs of issuance and debt service reserve funds.

## **Bond Covenants and Documentation**

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Finally, it is important for school administrators and boards to understand the obligations related to issuing bonds. These obligations are extensive and will be outlined in three key documents, the loan agreement, the trust indenture, and the deed of trust.

Prior to selling the bonds, the offering statement will provide an overview of the school, its financials, and a summary of the loan terms that the school is anticipating it will abide by. At closing, a representative of the school will sign the loan agreement, trust indenture, and deed of trust which will outline all of the details of the obligations of the school. These documents supersede the offering statement.

It is likely that the loan agreement, the trust indenture, and the deed of trust will total hundreds of pages. It is important that someone from the school takes the time to read and understand the obligations as early as possible in the drafting of these documents. While they are still in draft form, the school's attorney and financial advisor may be able to influence some of the provisions. If the school is at closing ready to sign, they will be nearly impossible to change.

There are many ongoing disclosures that the school will be obligated to comply with, but four of the most important are as follows:

- 1) Annual Audit—The school will be required to have an annual audit and it will have to be provided to the bondholders.
- 2) Debt Service Coverage Ratio—This is typically calculated by dividing the school's net operating income (NOI) by its maximum annual debt service (MADS)
- 3) Days Cash on Hand—This is the schools cash on its balance sheet divided by the schools operating expenses divided by 365. More than 90 days' cash on hand reflects a strong cash position for a charter school.
- 4) Annual Conference Call—The school will also likely have to participate in an annual conference call to be accountable to bondholders for complying with the covenants of the loan. Typical discussion items include enrollment, growth, financial performance, upcoming projects or significant changes, and covenant compliance.

This is not a comprehensive list of the covenants, nor is it a summary of all key covenants. To see a table of the charter school covenants monitored by credit rating agencies, see Exhibit E. This exhibit is particularly helpful for schools who want to compare their school's financial performance to benchmark credit indicators.

### **Credit Enhancement and Moral Obligation Products**

In an effort to help charter schools obtain lower interest rates, some states have created credit enhancement programs for charter schools that can obtain investment grade credit ratings.

Typically, charter school bond issues are not backed by the full faith and credit of the issuer. This means the issuer authorizes the school to issue under its authority,

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but the issuer does not guarantee the payments of the bonds. Credit enhancement is the process whereby the issuer makes the additional commitment to guarantee the payment of the bonds.

Most credit enhancement programs are not available to all schools. These programs typically have minimum credit rating standards, such as a credit rating of investment grade (BBB-), as well as a comprehensive application process. Schools who meet minimum requirements and are approved by their issuer for credit enhancement not only are authorized to sell bonds using the issuer's authority, they are now also receiving a guarantee of payment from the issuer. The guarantee results in a lower interest rate that can save schools tens or hundreds of thousands of dollars in interest payments per year.

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## Financial Advisors, Attorneys, Agents, and Others Who Help

This is one of the most difficult sections to address. Because most advisors sincerely want to help and are acting with good intentions, in many instances it is difficult to know if the school's advisors are actually helping or hindering the facility finance decisions of the school. Boards will ultimately be responsible for determining the effectiveness of the advisors they hire. Knowing the school's objectives will help provide a framework to evaluate advisor contributions. Following are some recommendations.

*Use extra caution when choosing individuals that are not experienced with charter school transactions.* The intent is not to dismiss those without experience; rather, the intent is to make sure they are qualified to help. For example, I have seen many attorneys, CPA's, and real estate professionals give poor advice or make poor decisions as board members because they didn't know what they didn't know. Charter school facilities transactions require real estate site selection, entitlement, construction, lease negotiation, and capital markets experience. Few have the background to span the processes, legal agreements, and economics of all of these disciplines.

*Watch closely individuals who claim to represent the school, but transact with the same parties consistently.* It is important to know who advisors represent not just on paper, but in practice. Where do their loyalties lie? If there is going to be a dispute, where will they line up? An attorney or financial advisor who always works with the same developer may not do a very good job of representing the school. An attorney or financial advisor who always works with the same investment bank may have stronger loyalties to the banker than the school. A dispute with the developer may put the attorney's relationship at risk.

*Make sure advisors are focused on the school's objectives.* Advisors tend to do what they know. What they know is what they did last time. What they did last time was to meet a different school's needs. Boards and administrators should ask themselves, "is this advisor focusing on the school's objectives, or are they doing what they did last time?"

*Insist on getting all questions answered.* An advisor who fails to answer questions either by ignoring them or dismissing them should be considered with caution. While the transaction may be routine for the advisor, they owe the school the time and consideration of making sure all questions are answered. Ultimately, the school's board and administration will be responsible for the decisions, and it is important that they have all the information they need prior to making those decisions.

*Be careful about rushing into transactions.* Nothing is worse than feeling like there is not enough time to make the right decision. Advisors who are pushing schools to

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hurry should be considered with caution. Time may actually be of the essence, but the time sensitivity should come from the school after determining for themselves that the school needs to be in a hurry.

*Preserve flexibility where possible.* One of the most difficult positions for a school to be in comes after the school has escalated its commitment to a particular course of action so significantly that it becomes nearly impossible to change course. Schools should not enter into contracts without having specific expiration dates, clear fee structures, and known breakup costs. Schools should know how to get out of an advisor contract if their advisor is not acting in the school's best interest.

*Negotiation is always an option.* Position the school to retain as much leverage as possible. Obtaining leverage in a negotiation is about creating options. If the school has three developers who will build the facility, the school has the leverage with the developers. If the school can terminate the financial advisor relationship, the school maintains the leverage. If the school has multiple facilities it can lease, the school has the leverage with the landlord. If the school only has a single option, the other party has the leverage.

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## Charter School Finance Innovations

Since the Great Recession, there have been a number of charter school facility finance innovations. While this is not a comprehensive list, it highlights some of the trends in charter school finance. Over the long term, the overriding themes are 1) more investors will become familiar with and comfortable with charter school finance, 2) lenders will find ways to better service the industry while remaining in compliance with banking regulations, and 3) state and local governments will incrementally increase their support for charter school facilities.

### **Bonding for Construction Costs**

It used to be that schools with very strong credit had to retain a developer to build an addition to the school or expand to a new campus. As charter school credit ratings improve, earlier access to capital markets may change the role of developers who provide financial capital as well as development expertise. Schools with superior credit will have more success taking advantage of this innovation in the short run.

### **REITs and Other Institutional Capital**

Charter school lending is still considered a niche market in finance circles. Many finance professionals do not understand the school funding, operations, and risk scenarios well enough to get involved in charter school finance. This is slowly changing. Developers with strong track records are raising money from sophisticated investors to help fund new charter school construction. Some of these agreements work very well for schools, and some create obligations that reduce the optionality of the school. This may be an appropriate choice for some schools and an undesirable outcome for others. As institutional capital becomes more comfortable with charter schools, the financing options will become even more diverse.

### **Pooled Bonds**

When charter schools first issued bonds, they were issued in pools where multiple schools were financed together. Strong schools quickly recognized that they were better off going to market on their own and pooled bonds fell out of favor. Some pooled structures may come back in vogue as schools look to increase the size of the offering and investors seek to reduce the exposure to any one school. At scale, pooled offerings of charter school facilities could decrease interest rates and debt service reserve requirements, which would make charter school bonds less expensive for schools.

### **Conventional Bank Loans**

While it may not sound that innovative for commercial banks to lend to charter schools, the emergence of traditional lenders who directly fund schools would have a significant impact on school debt service payments. There are a number of challenges that make this difficult today, but as commercial banks become more

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familiar with charter schools and their economics, this is a viable option that will allow schools to keep facility costs down.

### **Bridge Loan Products**

With capital markets and issuers becoming more comfortable with charter school bond issues, it is becoming more compelling for schools to see a quick exit from their developer lease into a bridge loan that will allow them to build their credit quality in advance of tapping into state credit enhancement bond programs. This is not a well-developed market, but providing the ability for schools to step down their facility cost as the school's startup risk fades and credit quality improves would save many charter schools money by reducing lease payments and improving access to inexpensive state credit enhancement products.

### **Wrap Financing**

In the few states that do not exempt school leased facilities from property taxes, this line item is a particular thorny challenge for new schools. Some developers are working through innovative ways to allow the school to own the facility in an effort to take advantage of the property tax exemption available to schools that own their facilities. It is important to make arrangements for this kind of transaction before executing agreements. There are potential tax implications for the developer and transaction structure changes for the school that make this kind of accommodation difficult after developer lease agreements have been signed.

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## Conclusion

In conclusion, boards and administrators who clearly define and stay focused on school facility objectives with the perspective of the entire facility finance process will find more success controlling facility costs. Understanding facility finance options early on in the process will allow schools to tailor a finance strategy that best meets the needs of the school. Preserving options along the way gives the school the flexibility to take advantage of opportunities that serve the best interest of the school.

It is easy to look at interest rates and make a decision. Unfortunately, rates only tell part of the story. It is critical for administrators and boards to understand the other fees and related costs—including the cost to purchase, extend, or otherwise exit the agreement. Going in, the deal may look great, while getting out is cost prohibitive. Last, make sure all of the school's questions are asked and answered. It may take more time, it may be frustrating to some that are knowledgeable, but it is important for the board and administration to have the knowledge that will allow them to make informed facility finance decisions.

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## About Neil Walter

Neil currently chairs the governing board at Vista at Entrada School of Performing Arts and Technology, a K-8 Charter School in Utah. He was responsible for Vista's \$13,300,000 bond issue in 2012. His experience in both real estate and capital markets was an advantage as he started learning about charter school finance in an effort to help Vista School. Since the successful bond issue, he has spent time with developers, underwriters, financial advisors, attorneys, state legislators, state treasurers, state school board members, other charter school administrators, charter school board members, and industry professionals. His objective is to help schools spend less on school facility finance so they have more resources to put into teacher compensation and the classroom.

Neil is Managing Director of NAI Excel, a commercial real estate brokerage, and CEO of Brokers Holdings which owns and operates NAI Excel and six residential real estate brokerages. The combined real estate operations close approximately 1,700 transactions each year. He is a licensed real estate broker in Utah, Idaho and Nevada and regularly markets and sells investment properties and special use assets.

Since 2006, Neil has taught finance and economics part time or adjunct at Dixie State University. His courses include Real Estate Finance, Investments, Financial Modeling and Decision Making, Entrepreneurial Finance, Statistics, Macro Economics, and Intro to Economics. Prior to moving to Southern Utah Neil priced derivatives and structured products and helped create risk metrics for the North America Natural Gas and Power trade floor at ConocoPhillips. He is a CFA charter holder and earned his MBA from Carnegie Mellon University.

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## About NAI Global

NAI Global provides a platform to service clients in every state in the United States and globally.

NAI Global is the single largest, most powerful global network of owner-operated commercial real estate brokerage firms. NAI Global member firms, leaders in their local markets, are actively managed to work in unison and provide clients with exceptional solutions to their commercial real estate needs.

NAI Global member firms spans worldwide, with 375 offices and more than 6,700 local market experts on the ground. Supported by the central resources of the NAI Global organization, member firms deliver market-leading services locally, and combine their in-market strengths to form a powerful bond of insights and execution for clients with multi-market challenges in the U.S. and/or globally.

Whether clients need to buy, sell, lease, finance, or manage commercial property locally, across the U.S. or in Asia, Europe, Latin America, and beyond, their nearby NAI Global owner-operated member is their local point of entry into a world of creative solutions in commercial real estate.

Exceptional global commercial real estate solutions begin with local market leadership and expertise. As members of the largest worldwide network of owner-operated, local market-leading commercial real estate brokers, NAI Global firms are respected local-market role models who are passionate about the commercial real estate business. With long histories of success across market cycles, NAI Global members have a hard-earned, unusually deep level of local market knowledge and insight beyond the commoditized data found elsewhere. This depth of knowledge is borne from their local relationships nurtured for generations – relationships that give our local-market leading members the edge with the know-how, who, what, where, and when to achieve exceptional results for clients.

As an organization, NAI Global actively manages this industry-leading platform of local market knowledge and leadership, providing support and services that yield seamless integration and the consistent delivery of exceptional services to clients both locally and in 55 markets around the world.

At NAI Global, our global strength is built on our local leadership. For more information about NAI Global, please visit [www.naiglobal.com](http://www.naiglobal.com).

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## Services Offered

### **Site Selection**

Site selection services involve finding a location for a school. This may include selecting raw land for new construction or existing facilities with or without tenant improvements. Site selection services are available for schools desiring to lease, purchase, or build-to-suit. Site selection services are offered across the United States.

### **Lease Abstracts**

Lease abstracting is the process of summarizing the key economic terms of a lease. Lease abstract services are offered across the United States.

### **Existing Facility Lease Negotiation**

With licensed professionals in every major market and in every state in the nation, facility lease negotiation services are available across the United States.

### **Developer Lease Facility Negotiation**

With licensed professionals in every major market and in every state in the nation, developer lease negotiation services are available across the United States.

In addition to developer facility negotiations, developer introductions are also available for schools looking to identify additional experienced charter school developers to bid on school projects nationwide.

### **Lease vs Buy Analysis**

For schools evaluating the tradeoffs between leasing and buying, the lease versus buy services can provide additional information and clarity for schools. Services are available for analyzing existing facilities or new facilities nationwide.

### **Facility Acquisition**

Schools looking to retain an experienced real estate broker to assist in the negotiation of the purchase of their facility may benefit from facility acquisition services. Whether the facility is the currently occupied building, or a new location, facility acquisition services are provided across the United States.

### **Facility Purchase Abstracts**

Schools who already have their facility purchase negotiated, but would like to have an overview of the economic terms of the purchase agreement prepared can take advantage of a facility purchase abstract. Services are provided across the United States.

### **Financing Cost Comparisons**

When there are multiple financing options and the choice is not clear, having a cost comparison of the financing alternatives may help provide information to clarify the

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decision. Financing cost comparisons should consider annual payments, fees, origination costs, prepayment penalties, and amortization schedules.

**Facility Management Services**

With asset and property management services across the United States, school facilities services are provided in most markets across the United States.

For more information about any of the services provided, please contact

Neil Walter, CFA, MBA  
direct 435 627 5720  
office 435 628 1609  
nwalter@naiexcel.com

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## Terms to Know

**BALANCE SHEET**—See Statement of Financial Position

**Bonds**—Bonds are debt sold as securities to investors. Charter school bonds allow investors to buy a portion of a school's debt without having to loan all of the proceeds.

**COMMON AREA MAINTENANCE or CAMs**—Common area maintenance charges are costs incurred by property tenants or owners that are shared by neighboring property owners. Shared expenses may include access and parking lot maintenance, landscaping, lighting, management fees, property insurance, maintenance, shared access or hallways, or other utilities that are not individually metered. Often, lease rates are quoted without including CAM charges. To get a better picture of the total cost of leasing or owning a property, it is important to know if there are CAMs and how much they will be. Typically, they must reflect actual operating costs and should not be a profit center for any party.

**CAPITAL LEASE**—A capital lease is an equipment or facility lease where the lease payments are converted to a depreciation and interest charge on the school's income statement or equivalent, sometimes called a statement of activities. Even though the school doesn't own the asset and is leasing it, the estimated value of the facility or equipment will show up on the school's balance sheet or equivalent, (sometimes called a statement of financial position). The lease will show both as an asset with an offsetting liability. Depending on the structure, the asset and liability dollar amounts may not be the same. To learn more about calculation of the asset, the liability, the depreciation, the interest expense, or whether or not a lease qualifies as a capital lease, consult the school's CPA.

**CAPITALIZATION RATE or CAP RATE**—The CAP rate is a measure of return. It is calculated by dividing the annual net operating income by the purchase price or development cost, in the case of a newly constructed charter school. Given a lease rate of \$500,000/year and a facility cost of \$5,000,000, the CAP rate is  $\$500,000/\$5,000,000$  or 10%. Purchase prices may also be quoted as CAP rates. For example, if the purchase price is a 10% CAP and the net operating income is \$500,000 the purchase price is  $\$500,000/10\% = \$5,000,000$ .

**CHANGE IN NET ASSETS**—The charter school equivalent of net income. It represents an accrual accounting of revenues less expenses. It is found on the statement of activities in the audited financials.

**CLOSED BOOK DEAL**—A closed book deal is a developer build to suit where the developer takes responsibility for all of the costs of the facility. If the developer can save money, the developer benefits. When there are decisions to make that impact

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the cost of the facility, the developer makes them. Change orders by the school will impact the total project cost.

**CONSUMER PRICE INDEX or CPI**—This index is prepared and maintained by the United States Bureau of Labor Statistics. It is commonly used to calculate lease rate escalations in both commercial leases and build to suit lease agreements. It measures the change in prices for goods that an average consumer in the United States would buy. It is calculated each month by the government and reported as the key metric for measuring inflation. More information is available at the Bureau of Labor Statistics website here: <http://www.bls.gov/cpi/>

**COSTS OF ISSUANCE**—These are the fees associated with a bond offering that can include legal fees, financial advisor fees, underwriter fees, title fees, rating fees, inspection fees, title insurance, trustee fees, and administrative expenses. Costs of issuance typically range between 3 and 7% of the purchase price of the school.

**DAYS CASH ON HAND**—This ratio is calculated by dividing the cash on the balance sheet of the school (not including the debt service reserve funds) by operating expenses for the fiscal year divided by 365. For example, if a school has \$1,000,000 in cash on hand and its annual operating expenses are \$4,000,000 then the days cash on hand would be  $\$1,000,000 / (\$4,000,000 / 365) = 91$ . Days cash on hand greater than 90 is a strong metric for charter schools.

**DEBT SERVICE COVERAGE RATIO (DSCR)**—This ratio is calculated by dividing the Net Operating Income by the debt service (including both principal and interest). Common DSCR minimum ratios are frequently 1.2 or 1.1. Schools with investment grade credit ratings often have DSCR ratios of 1.4 or more.

**DEBT SERVICE RESERVE FUND**—In a bond issue, it is common to borrow more than the purchase price by an amount approximately equal to the largest annual debt service payment. This additional amount is held by a trustee in the event the school defaults on its bonds. The debt service reserve funds are typically applied to the final payment the school makes to pay off its bonds at maturity.

**INCOME STATEMENT**—See Statement of Activities

**INVESTMENT BANK**—A bank licensed to sell securities to accredited investors or retail investors. Investment banks typically perform underwriting for charter schools who are issuing bonds, they identify potential investors, and they work with the charter school to get the best rate and terms for the sale of the bonds.

**LEASE ABSTRACT**—A summary of the key economic terms, dates, and parties to a lease agreement. It should also show the cash flows of the lease with contractual escalations. If there are additional charges showing them or noting them is helpful.

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**LETTER OF INTENT**—A letter of intent is an expression of interest between the parties to work together based on key economic terms of the transaction. Typically, a letter of intent is non-binding and requires no cash deposit. The letter of intent does not address every component of the agreement between the parties. After a mutually agreeable letter of intent is signed, the parties have the opportunity to perform due diligence to their satisfaction within a specific period of time.

**LOAN-TO-VALUE (LTV) Ratio**—The loan-to-value ratio is the amount of money borrowed divided by the total project cost or the total purchase price. For example, if a school intends to borrow \$3,000,000 to purchase a facility for \$5,000,000, the loan to value would be 60%.

**MAXIMUM ANNUAL DEBT SERVICE (MADS)**—this is the maximum annual payment in any given year of the loan.

**MAXIMUM ANNUAL DEBT SERVICE COVERAGE RATIO**—This is the same calculation as DSCR, but instead of using the debt service in the current year, calculations should use the maximum debt service in any year of the loan.

**NET ASSETS**—this is the charter school equivalent of equity or owner's equity on a typical balance sheet. It represents the difference between assets and liabilities.

**NET OPERATING INCOME (NOI)**—NOI is an estimate of cash flow that excludes debt service (or facility lease payments), depreciation, and property taxes (if they will no longer be paid after financing). Below are two calculations for NOI in the context of charter schools. The first is for a facility that is owned by the school, or leased under a capital lease structure

[NOI = change in net assets or net income + depreciation + interest expense + property taxes (if they will no longer be paid)].

The second is for a facility that is leased by the school in an operating lease structure.

[NOI = change in net assets + depreciation + interest expense + lease payment + property taxes (if paid on a lease and not on a purchased facility)].

**OPEN BOOK DEAL**—An open book deal is a developer build to suit where the developer shares documentation regarding all of the costs with the school. When there are decisions to make that impact the cost of the facility, the developer makes them in conjunction with the school, including change orders. If the developer saves money, the benefit accrues to the school.

**OPERATING LEASE**—This is the typical form of a lease that most people are familiar with. It may apply to equipment or a facility. The school does not own the asset; it is leasing it. In exchange for using the asset, the school pays a periodic lease

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payment that is an expense to the school. The expense shows up on the school's equivalent of an income statement (sometimes referred to as a statement of activities). There is no reference to the asset on the school's balance sheet or equivalent (sometimes referred to as a statement of financial position). Also see Capital Lease.

**PAR**—The face value of the debt that is being issued on a bond. If an issue is offered at a discount to par, then it means an amount less than the face value of the bonds will be raised.

**STATEMENT OF ACTIVITIES**—The charter school equivalent of the income statement. It is an accrual accounting of a school's revenue and expenses.

**STATEMENT OF FINANCIAL POSITION**—the charter school equivalent of the balance sheet. It is an accrual accounting a school's assets, liabilities, and net assets.

**TENANT IMPROVEMENTS**—Costs incurred by the tenant or landlord to make an existing facility ready for occupancy. For an existing facility that needs improvements, the landlord or tenant will have to invest to make the facility ready for the school. With new facilities, they may be delivered as a "vanilla shell" or mostly complete, but the school or developer will have to invest additional money into the facility to make it ready for students and teachers. Collectively these investments are considered tenant improvements (even if the landlord pays). There is not a standard protocol for who pays for which improvements; they typically are negotiated with each transaction.

**TOTAL PROJECT COST**—This is the cost of construction for a new school. The total project cost is often the basis for setting the lease rate and the purchase option price. It typically includes land, site preparation costs, vertical construction costs, engineering and architectural costs, licensing and permitting costs, contractor and subcontractor fees, attorney's fees, brokerage fees, accrued interest, and developer fees.

**TRANCHE**—A tranche is a portion of a bond issue that has a separate maturity, interest rate, or both.

**UNDERWRITER**—The underwriter for a conventional loan is the individual or team who reviews and assembles the loan package to be presented to the bank's loan committee. For a bond issue, the investment bank will assemble the loan package into an offering statement to be provided to prospective investors. For this reason, the investment bank is sometimes referred to as the underwriter because they "underwrite" the bonds.

## EXHIBIT A: Sample Pro Forma Financials, DSCR, and Cash on Hand

Year	Year 1	Year 2	Year 3	Year 4	Year 5
<b>% of Revenue</b>					
Revenue					
Local	37,200	38,130	39,083	40,060	41,062
State	3,348,000	3,431,700	3,517,493	3,605,430	3,695,566
Federal	334,800	343,170	351,749	360,543	369,557
<b>Total Revenue</b>	<b>\$ 3,720,000</b>	<b>\$ 3,813,000</b>	<b>\$ 3,908,325</b>	<b>\$ 4,006,033</b>	<b>\$ 4,106,184</b>
<b>Operating Expenses</b>					
Salaries	1,748,000	1,791,700	1,836,493	1,882,405	1,929,465
Employee Benefits	409,000	419,225	429,706	440,448	451,459
Professional and Technical Services	364,000	373,100	382,428	391,988	401,788
Insurance and Utilities	112,000	114,800	117,670	120,612	123,627
Supplies	186,000	190,650	195,416	200,302	205,309
Interest or Lease Expense	521,000	534,025	547,376	561,060	575,087
Depreciation	186,000	190,650	195,416	200,302	205,309
<b>Total Operating Expenses</b>	<b>\$ 3,526,000</b>	<b>\$ 3,614,150</b>	<b>\$ 3,704,504</b>	<b>\$ 3,797,116</b>	<b>\$ 3,892,044</b>
<b>Net Income</b>	<b>\$ 194,000</b>	<b>\$ 198,850</b>	<b>\$ 203,821</b>	<b>\$ 208,917</b>	<b>\$ 214,140</b>
<b>Adjustment for Interest/Lease</b>					
Adjustment for Property Taxes (if applicable)	521,000	534,025	547,376	561,060	575,087
Adjustment for Depreciation	186,000	190,650	195,416	200,302	205,309
<b>Net Operating Income</b>	<b>\$ 901,000</b>	<b>\$ 923,525</b>	<b>\$ 946,613</b>	<b>\$ 970,278</b>	<b>\$ 994,535</b>
MADS	750,833	769,604	788,844	808,565	828,780
DSCR @ \$626,240	1.44	1.47	1.51	1.55	1.59
<b>Lease Payment and Prop. Taxes</b>					
Cash Flow after Lease Payment and Property Taxes	488,000	672,000	673,600	690,440	710,817
<b>New Capital Investment</b>	<b>\$ 413,000</b>	<b>\$ 251,525</b>	<b>\$ 273,013</b>	<b>\$ 279,838</b>	<b>\$ 283,718</b>
Cash on Hand	100,000	100,000	100,000	100,000	100,000
Days Cash on Hand	313,000	464,525	637,538	817,377	1,001,095
	32	47	63	79	94

## EXHIBIT B: Sample Lease Abstract

### Sample: Lease Abstract and Executive Summary

Facility Summary		Lease Schedule				
Estimated Enrollment	600	Year	Lease Pmt	*Purchase Option	\$/SF	Prop Taxes
Estimated Revenue/Student	\$6,200	1	\$ 456,000	None		\$ 32,000
Estimated Total Revenue	\$3,720,000	2	\$ 608,000	None		\$ 64,000
Building Size	40,000	3	\$ 608,000	None		\$ 65,600
Monthly Lease Payment	\$ 50,667	4	\$ 623,200	\$ 8,000,000	\$ 200.00	\$ 67,240
Annual Lease Payment	\$ 608,000	5	\$ 641,896	\$ 8,000,000	\$ 200.00	\$ 68,921
Total Project Cost	\$ 6,400,000	6	\$ 661,153	\$ 8,264,411	\$ 206.61	\$ 70,644
Cost/SF	\$ 160.00	7	\$ 680,987	\$ 8,512,343	\$ 212.81	\$ 72,410
Land Cost	\$ 475,000	8	\$ 701,417	\$ 8,767,714	\$ 219.19	\$ 74,220
Improvements	\$ 5,925,000	9	\$ 722,460	\$ 9,030,745	\$ 225.77	\$ 76,076
Lease Commencement	Jul. 1, Yr 1	10	\$ 744,133	\$ 9,301,667	\$ 232.54	\$ 77,978
Rent Commencement	Oct. 1, Yr 1	11	\$ 766,457	\$ 9,580,717	\$ 239.52	\$ 79,927
Lease Escalations begin	Jul. 1, Yr 4	12	\$ 789,451	\$ 9,868,139	\$ 246.70	\$ 81,925
Escalation Amount	2.5%	13	\$ 813,135	\$ 10,164,183	\$ 254.10	\$ 83,974
New Monthly Lease Amount	\$ 52,187	14	\$ 837,529	\$ 10,469,109	\$ 261.73	\$ 86,073
New Annual Lease Amount	\$ 626,240	15	\$ 862,655	\$ 10,783,182	\$ 269.58	\$ 88,225
Lease Expiration	Jun. 30, Yr 20	16	\$ 888,534	\$ 11,106,677	\$ 277.67	\$ 90,430
Purchase Option	Jul. 1, Yr 4	17	\$ 915,190	\$ 11,439,878	\$ 286.00	\$ 92,691
urchase Option as % of Cost	125%	18	\$ 942,646	\$ 11,783,074	\$ 294.58	\$ 95,008
Purchase Option as CAP R <sub>e</sub>	8%	19	\$ 970,925	\$ 12,136,566	\$ 303.41	\$ 97,384
Estimated Property Taxes	\$ 64,000	20	\$ 1,000,053	\$ 12,500,663	\$ 312.52	\$ 99,818

\*Purchase prices may include deferred rent

## EXHIBIT C: Sample Senior/Subordinate Loan Amortization

### Sample Senior/Subordinate Loan Amortization Schedule

Purchase Price:	\$ 10,000,000
Down Payment:	\$ 2,500,000
Loan Amount:	\$ 7,500,000
Annual Payment	\$831,630
Equivalent CAP Rate	8.3%

#### Senior Lender (Bank or Credit Union)

APR	6.0%
Payments/Year (y)	\$ 12.00
Periodic interest rate (r <sub>p</sub> )	0.50%
Principal Amount (p)	\$ 7,500,000
Term (years) (n/y)	25
Payment (pmt)	\$48,323
Annual Payment	\$579,871

Period	Interest Payment	Principal Payment	Outstanding Principal
1	\$37,500	\$10,823	\$7,489,177
2	\$37,446	\$10,877	\$7,478,301
3	\$37,392	\$10,931	\$7,467,370
4	\$37,337	\$10,986	\$7,456,384
5	\$37,282	\$11,041	\$7,445,343
6	\$37,227	\$11,096	\$7,434,247
7	\$37,171	\$11,151	\$7,423,096
8	\$37,115	\$11,207	\$7,411,889
9	\$37,059	\$11,263	\$7,400,626
10	\$37,003	\$11,319	\$7,389,306
11	\$36,947	\$11,376	\$7,377,930
12	\$36,890	\$11,433	\$7,366,497

#### Subordinate Lender (Private Capital)

APR	9.0%
Payments/Year (y)	\$ 12.00
Periodic interest rate (r <sub>p</sub> )	0.75%
Principal Amount (p)	\$ 2,500,000
Term (years) (n/y)	25
Payment (pmt)	\$20,980
Annual Payment	\$251,759

Period	Interest Payment	Principal Payment	Outstanding Principal
1	\$18,750	\$2,230	\$2,497,770
2	\$18,733	\$2,247	\$2,495,523
3	\$18,716	\$2,263	\$2,493,260
4	\$18,699	\$2,280	\$2,490,980
5	\$18,682	\$2,298	\$2,488,682
6	\$18,665	\$2,315	\$2,486,367
7	\$18,648	\$2,332	\$2,484,035
8	\$18,630	\$2,350	\$2,481,685
9	\$18,613	\$2,367	\$2,479,318
10	\$18,595	\$2,385	\$2,476,933
11	\$18,577	\$2,403	\$2,474,530
12	\$18,559	\$2,421	\$2,472,109

#### Combined

APR	6.8%
Periodic interest rate	0.6%
Total Principal	\$ 10,000,000
Total Payment	\$69,303
Annual Payment	\$831,630

Total Payment	Outstanding Principal
\$69,303	\$9,986,947
\$69,303	\$9,973,824
\$69,303	\$9,960,630
\$69,303	\$9,947,363
\$69,303	\$9,934,025
\$69,303	\$9,920,614
\$69,303	\$9,907,131
\$69,303	\$9,893,574
\$69,303	\$9,879,944
\$69,303	\$9,866,239
\$69,303	\$9,852,460
\$69,303	\$9,838,606

## EXHIBIT D: Sample Bond Issue

<b>Charter School Metrics</b>	<b>Assumptions</b>
Building Size	40,000
Purchase Price/SF	\$ 200
Facility Purchase Price	\$ 8,000,000
Enrollment	600
Annual Revenue @ \$6,200/Student Effective	\$ 3,720,000

<b>BB+ Bond Issue</b>	<b>Assumptions</b>
Interest Rate on Bond Issue	7.0%
Term (years)	30
Total Bond Issue	\$ 9,227,347
Costs of Issuance and Debt Service Reserve	\$ 1,227,347
Annual Payment	\$ 743,599
Price/SF	\$ 231
Property Taxes	\$ -
Annual Payment as a % of School Revenue	20.0%

<b>Issuance Costs</b>	<b>Assumptions</b>
Purchase Price	\$ 8,000,000
Issuers Counsel	\$ 22,000
Bond Counsel	\$ 35,000
Borrower's Counsel	\$ 60,000
Underwriters Counsel	\$ 42,000
Trustee Setup Fee	\$ 1,500
Annual Trustee Fee	\$ 1,800
Financial Advisor	\$ 60,000
Administrative Expenses	\$ 5,000
Rating Fee	\$ 30,000
Building Inspection	\$ 3,500
Underwriter's Fee	\$ 184,547
Title Insurance	\$ 32,000
Debt Service Reserve Fund	\$ 750,000
Bond Issue	\$ 9,227,347
<b>Total Costs of Issuance</b>	<b>\$ 1,227,347</b>

This is a hypothetical scenario. Each individual transaction will differ. These assumptions are not representative of any particular school.

## EXHIBIT E: Key Charter School Covenant Benchmarks

Below is an overview of key covenants for charter schools based on their credit rating. This table comes from a Standard and Poor's Ratings Direct publication on charter schools published on June 25, 2014. The entire report is available at <http://www.standardandpoors.com/ratingsdirect>.

**Table 2**

<b>Charter School Median Comparison*</b>								
	<b>BBB+/BBB</b>		<b>BBB-</b>		<b>BB+</b>		<b>BB/BB-</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
No. of schools	24	25	96	106	45	32	38	21
Enrollment	1,531	1,344	799	697	935	864	957	997
EBIDA margin (%)	17.9	16.6	14.4	12.1	12.9	12.7	11.4	10.1
Excess margin (%)	3.8	3.5	1.3	2.0	1.5	2.6	1.1	(0.1)
Lease-adjusted annual debt service coverage (x)	1.6	1.6	1.4	1.4	1.2	1.3	1.3	1.1
MADS (\$000)	2,090	1,474	930	793	1,013	968	1,300	1,444
Lease-adjusted MADS coverage (x)	1.6	1.5	1.3	1.3	1.2	1.3	1.0	1.1
Lease-adjusted MADS as a percent of state aid (%)	14.8	13.1	16.3	15.0	19.8	15.8	18.6	17.9
Lease-adjusted MADS debt burden (%)	12.2	11.4	13.1	12.2	15.2	12.7	15.5	15.0
Unrestricted days' cash on hand	153	156	99	67	69	44	35	44
Unrestricted cash to debt (%)	27.5	26.0	15.9	13.0	12.2	12.0	6.8	8.0
Unreserved net assets as a percent of operating expenses	36.6	35.0	25.7	22.0	19.5	17.0	10.9	10.0

\*Fiscal year. MADS--Maximum annual debt service.

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**Questions or Comments?**

R. Neil Walter, CFA, MBA  
243 E St. George Blvd STE 200  
St. George, UT 84770  
Direct 435 627 5720  
Office 435 628 1609  
[nwalter@naiexcel.com](mailto:nwalter@naiexcel.com)