BUCK
FINANCIAL

MEMORANDUM

TO: Fitch Ratings

FROM: John Buck, Buck Financial Advisors LLC

DATE: August 20, 2012

RE: Comments: Charter School Rating Criteria: Exposure Draft

Executive Summary

As proposed, Fitch's criteria have a tendency to focus on a narrow range of metrics, or take a one-sided view, to determine the dividing line between investment grade and non-investment grade ratings. The exposure draft applies too broadly the external risks to charter school operations. It is also inconsistent with its analysis of operational flexibility of charter schools. It misdiagnoses the importance of revenue diversity, and proposes nonsensical limits on potential ratings. The proposed leverage metrics do not take into account the most practical and informative leverage measure for a charter school.

Chartering Environment

- It is appropriate to focus on the length of the operating history, renewals and the relationship with the authorizer. It is misleading, however, to conclude that a charter school with an operating history of less than five years poses non-investment grade risk in all circumstances.
- By acknowledging that charters which do have both five years of operating history as well as a renewal won't automatically receive an investment grade rating supports that a wider range of metrics should be considered than just five years of history. Fitch is inconsistent with its own criteria here.

External Factors

- External risks are too broadly applied. To be direct, Fitch is taking some adverse events on a few of its credits and erroneously applying them as symptomatic of the entire charter industry.
- For example, establishing a cap on a charter school's rating based upon the local school district's rating if authorized or funds flow through is nonsensical. If anything, there could be an inverse relationship, but nonetheless the assessed value of a school district and the demand characteristics of a charter school such as test scores bear no relation to one another. This is an over-reaction to the PA situation, and ignores state law and due process, and the factors that generate cash flow for each entity.
- The conclusion that charter authorizers pose risk because they are political bodies ignores the political climate in a particular jurisdiction and the POSITIVE influence that can have.

Enrollment

- The focus on the size of the enrollment is appropriate but the dogmatic approach to growth is not. High demand for successful CMO's creates the ability to grow, and Fitch's proposed criteria penalize such entities for their own success. What might be appropriate is the development of dual sets of criteria, one for stand-alone schools and one for growing CMOs.
- Other factors/metrics such as an underperforming school district, a successful history of managing growth and hitting targets, and a strong wait list that is culled annually can offset risks caused by the inability to cover MADS based upon historical Net Revenues. So can the use of strict underwriting criteria in deciding upon expansion.
- It is also appropriate, within limits, to structure the debt to match a short enrollment ramp-up period versus level debt service at issuance that could over-burden the existing budget.

Demand Flexibility

- Performance on assessment tests is one of the main reasons charters were begun, and one of the more important performance metrics against which renewal will be measured. To state that Fitch views above-average academic performance as insufficient to maintain or renew a charter, and the resulting implications on rating, underscores that multiple factors determine charter success. It follows that multiple factors should also determine the rating.
- Yet despite the above, Fitch continually emphasizes a limited number of factors, or takes a one-sided view of a factor, in its assessment of what can or cannot be an investment grade financing.
- Stating that charters may be held to different (higher) standards than local school districts does not necessarily create risk for non-renewal. Higher standards are more likely to increase demand for the charter school, especially if the charter's academic results are superior to the local educational options. Superior academic results can mitigate many perceived risks.
- The existence of an appropriate appeal process and/or alternative authorizing options must be considered in assessing risk of non-renewal in any case. Many states have very favorable environments that protect charters from political interference and/or dual standards. This risk is too broadly applied to the entire industry in the proposed criteria.
- The likelihood of new market entrants is noted as a credit negative, yet a growing CMO can possibly preclude the entrance of such competition. Additionally, new entrants can be a sign of an underperforming school district and/or a supportive environment for charter schools.

Wait List

- For states that have a single day count-date, it would not matter whether the charter accepts students beyond a certain point. In such instances, not accepting students after a certain point may be financially positive, in fact, by avoiding expenses when no marginal revenues are received. Further, student retention may preclude the need to use the wait list.

Expenditure Flexibility

- There are conflicting assessments of a charter's operational flexibility. Fitch raises this issue, and goes on to note charters have more discretion to manage expenses than school districts.
- Charter schools, as an industry, are typically not subject to collective bargaining.
- Many revenue sources are reimbursements for expenditures, a fact which provides significant flexibility and control in budgeting, and pose less risk to the school's bottom line.
- Finally, charter schools' need to actually perform academically helps create demand for those charters that do perform, helping to smooth the revenue base and mitigate operational risks.

Concentrated Revenues

- Fitch's concern regarding revenue diversity is completely off the mark. It should be a credit positive that a charter school can successfully operate solely within the funding from state and federal sources, as those are the revenues most under their control.
- Philanthropy is noted as a possible source of revenue diversity, but reliance on philanthropy for basic program services is riskier than operating on state and federal revenues.
- Too much emphasis is placed on an intercept. It provides limited cushion, at best, and the market has moved on.
- Any charter that balanced a budget in a decreasing revenue environment has demonstrated both operational flexibility and the ability to develop a contingency plan.
- The issue should not be revenue diversity, as what diversity of revenues does a utility system have? Rather, the issue is the inability to set rates, as utilities can.
- This, then, raises in importance the ability to attract students as measured by numerous factors including test results, wait list, and student retention, to lessen potential deviations from the budget.

Balance Sheet Resources

- The Net Debt to Available Income approach may cause false concerns (or comfort) about leverage because it doesn't take into account other factors, such as interest rate for example.
- A better approach is the previously denoted analysis regarding the percent of the budget needed for debt service, though not in itself a balance sheet resource.
- Federal and other restricted revenues are reimbursements of expenditures for designated purposes. These should be included in calculations of debt burden along with unrestricted revenues because these programs impact the facility, and, as noted before, are controlled more easily by the school.
- Liquidity is a better measure of balance sheet resources, and one that is most emphasized by charter school investors.

Capital Plan

- Understanding the underwriting criteria a charter school undertakes prior to deciding to expand is a good addition to your criteria.
- As is encouraging disclosure of future financing plans in current financing projections.

Debt Profile

- Covenants are a useful “early warning system”, and the use of ratios (versus absolute values) removes risk associated with projected revenues, expenses, and fund balances.
- The inclusion of adequate continuing disclosure requirements, and the school’s ongoing compliance with these requirements, should also be considered in assessing risk.

Debt Manageability

- Primary indicators are on point, but the Net Debt to available income is not. It risks under- or over-measuring debt burden based upon factors not considered, such as interest rate.

Ratios

- Fitch is one-sided in its assessment that qualitative factors will typically offset quantitative factors in a negative direction. See earlier comments on political environment, for example.

Conclusion

The charter school landscape has not changed for the worse over the last decade; it has gotten stronger. More states are offering this alternative to the traditional public schools, reflecting the increased and continuing demand for charter schools. Since the money follows the students, this makes the industry stronger. While industry characteristics should lower the possible ratings versus other municipal categories, Fitch goes too far in limiting the circumstances for assigning investment grade ratings.

It is true the success of the industry has attracted its opponents, and in some instances made them more aggressive, and this needs to be considered in any risk assessment. However, as charters typically operate on less public funding, especially when including the cost of financing facilities for traditional public schools, even academic performance that is only on par with traditional public schools is a public policy win and will engender political support, particularly in challenging economic times. As a result, Fitch’s assessment of the impact of environment on credit quality is too broad and excessively negative.

Fitch’s revamping of its criteria is overly affected by problems with a limited number of credits it assesses, not with the industry as a whole. For a true and accurate credit analysis, a wider range of factors must be considered in assigning a rating that is truly reflective of the risk of non-payment.