

Risks and Opportunities in the U.S. Charter School Sector

■ **The U.S. education market is at a crossroads**, where an unprecedented upsurge in demand for education at all levels is both straining the capacity of traditional schools, colleges and universities and is spawning the creation and growth of many new education models and providers. *Chartering*—permitting the private creation of publicly funded schools—is a key

strategy in America’s attempt to respond to such demand. As it rapidly evolves from a movement to a full-fledged industry, the charter school sector represents a particularly unique opportunity for investors to get involved early on. For those willing to educate themselves about this market—they will find the risks can be both predictable and manageable.

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INTRODUCTION

■ **More than ever, the education scene in America is at a crossroads.** Social, political, technological, demographic and socioeconomic factors have converged to show a new way forward. Accounting for just 5 percent of U.S. schools but constituting 18 percent of the top 100 schools in the nation, charter schools are at the forefront of that change, but remain a nascent industry.

There are clear opportunities, but what was not so long ago a movement has only recently emerged to form a leading-edge, albeit loosely organized and variably-grown sector. Both new and mature charter school organizations—from mom-and-pop sized (in many cases single schools or just three or fewer schools) to increasingly larger (organizations with 20 or more schools)—dot the landscape.

Here, we seek to address what a charter school is, to offer a profile and to show how they perform. We explore the evolution of the movement, its emergence as an industry; challenges regarding financial performance and stability, and opportunities relating to the financing of facilities.

Through such schools, leaders have been successful in forwarding strong social purposes (excellence and equity in education). Charter schools have enjoyed unprecedented bipartisan support (from the Clinton, Bush and now Obama administrations and Congress). They have provided education leaders a vehicle to move forward improved alternatives to many existing public schools.

We are at a unique stage: charter schools enjoy the strongest, most supportive environment ever; new, innovative providers enter the space in response to unmet demand—but understanding the risks and barriers involved is essential. In fact, the barriers represent opportunities—if you have ways to resolve them.

In this Charter Schools 101, the savvy investor may indeed discover that charter schools can present an acceptable and manageable level of risk, juxtaposed with the steady, stable potential revenues they ultimately can provide.



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■ What is a Charter School?

- Definition.
- Why they exist.
- Types
- Enrollment.
- Who operates.
- Who authorizes.
- Regulation.

DEFINITION. Charter schools are "...independent public schools that are allowed the freedom to be more innovative [than regular public schools] while being held accountable for improved student achievement," according to the National Alliance for Public Charter Schools.

The "charter" establishing each such school is a performance contract detailing the school's mission, program, goals, students served, methods of assessment and ways to measure

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success. The length of time for which charters are granted varies; most are 3-7 years, the vast majority renew without issue.

They are still public schools in that they:
-remain tuition free and open to any student who wishes to enroll (although many have wait-lists);
-they are nonsectarian and cannot discriminate when enrolling students;
-like regular public schools, they're publicly funded through a combination of local, state and federal tax dollars; and
-they're held accountable to state and federal academic standards.

WHY THEY EXIST. Foremost among the many reasons charter schools exist: there is an overwhelming demand for quality, innovative education. They're often started by parents, teachers, principals and community organizations to serve the needs of the community.

TYPES. Charter schools come in a wide variety of types, including traditional and nontraditional schools; they may include hybrid virtual learning environments. Charter schools can span any combination of grades. They also run under a variety of academic themes. From a legal standpoint, they can be profits or nonprofits. Some are part of a nonprofit charter management organization (CMO) or are contracted out to a for-profit education management organization (EMO). There are also wholly independent self-managed charter schools.

WHO ENROLLS? Charter schools tend to be small (less than 300 students) and are primarily new schools, although some are traditional public schools who have converted to become a charter school. They are highly concentrated in urban locales but depending on the state, there is tremendous variation in rural and suburban concentrations. They are generally more racially diverse than regular public schools, though they enroll slightly fewer special needs and limited-English students. By 2007, 54 percent of charter students qualified for free or reduced lunches.

WHO OPERATES? In most cases, the charter school is operated by a local charter school board and leadership team. In a growing number of cases, a charter school may contract to be operated and/or supported in part by a charter management organization or an education management organization. In rare cases, the local school district operates the charter school (district-dependent charter schools).

WHO AUTHORIZES? State legislatures create and modify the laws which enables the creation of charter schools. Entities that may legally issue charters (it varies by state) include states, local school districts, counties, and in some cases colleges and universities, cities, counties and, in rare cases, nonprofit organizations.

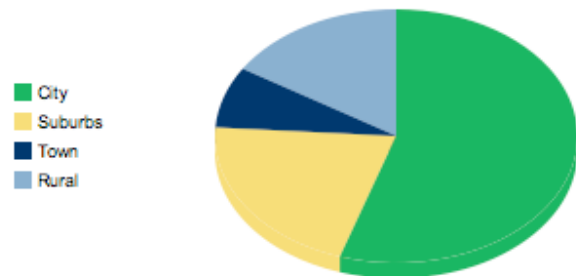
WHO REGULATES? Charter schools are expected to follow the same health, safety and accountability laws as established by state and federal law requirements as do regular public schools. They are also subject to requirements and regulations that are tied to specific federal and state grants and funds like regular public schools. Charter schools are generally free from local district regulations and procedures and have more flexibility around curriculum, schedules, buildings and staffing.

■ Sector Profile

- How many exist, annual growth.
- Concentrations.
- Types of growth and changes.
- Future growth, drivers, barriers.
- Areas of risk.

HOW MANY EXIST, ANNUAL GROWTH. According to the National Alliance for Public Charter Schools, nationally there were 4,919 charter schools representing 5.1 percent of all public schools. Compare that to 1999-2000, when nationally there were just 1,542 charter schools comprising 1.7 percent of all public schools. Charter schools have been on a sure course of continual, steady growth over the past decade. In the fall of academic year 2009-2010, there were 443 new charter schools, while that same year 160 closed. The percentage growth in the overall number of charter schools showed a steady rise to 6.2 percent.

Charter Schools		
Metrics	#	%
City	2,552	55.0%
Suburbs	977	21.1%
Town	362	7.8%
Rural	747	16.1%



Source: www.publiccharters.org

CONCENTRATIONS. The highest percentage of charter schools are found in urban environments (55 percent). For 2009-2010, the top ten charter school areas in the U.S.—those regions with the highest percentage of the overall number of public school students attending charters in their respective regions—are as follows: New Orleans, **Louisiana** (61.5 percent), Washington, **D.C.** public (38 percent), Dayton, **Ohio** Public Schools (32 percent), Southfield, **Michigan** (31.9 percent), Kansas City, **Missouri** (31.5 percent), Gary, **Indiana** (27.7 percent), DeSoto, **Texas** (27.5 percent), Saint Louis, **Missouri** (26.7 percent), Detroit, **Michigan** (25.5 percent) and Albany, **New York** (24.5 percent). For 2010, **Los Angeles** was ranked number 1 in charter school enrollment (68,469) serving 10 percent of the total district's enrollment, according to the National Association of Public Charter Schools, and remains one of the most active and supported regions in the country for charter school growth and stability. All of these regions (except for wholly over-saturated areas like New Orleans), have ample room for further growth.

TYPES OF GROWTH, CHANGES. A larger proportion of new charter school growth is from CMO/EMOs; we may see an uptick in conversion charter schools due to the Obama administration's *Race to the Top* and the targeting of the lowest-performing schools for closure under the *Race to the Top* program. We are also seeing growth in virtual schools (where most of the instruction is completed online via the web). Data on virtual schools is very limited but there are now 219 (4.5 percent of total enrollment) virtual schools; 134 (2.7 percent) are hybrid virtual schools that combine classroom instruction with online instruction.

FUTURE GROWTH, DRIVERS, BARRIERS. Growing current charter school waiting lists, the removal

Schools		
Number of Schools	4,919	
% of Charter Schools to All Public Schools		5.1%
Average Number of Years Open		
Average Number of Years Open	6.7	
Number of Years Open		
Open 1-3 Years	1,314	26.7%
Open 4-6 Years	1,300	26.4%
Open 7-9 Years	930	18.9%
Open 10+ Years	1,375	28.0%
Growth		
Number of New Charter Schools in Fall of Academic Year	443	
Number of Charter Schools That Closed During Academic Year	160	
% Growth in Number of Charter Schools	6.2%	
Schools by Grade Levels		
Elementary Schools	2,107	42.8%
Middle Schools	488	9.9%
High Schools	1,029	20.9%
Middle/High Schools	524	10.7%
Elementary/Middle/High Schools	552	11.2%
Ungraded	219	
Conversion/Start-up		
Conversion	455	9.2%
Start-Up	4,462	90.7%

Source: www.publiccharters.org

of state caps, and continuing bipartisan support all signal future growth for charter schools and will continue to drive the market toward rapid expansion. Barriers include problems with organizational quality and effective curriculum, and inability to scale for lack of capital/facilities/personnel. Currently, more than 1.6 million

CAPPED BUT WAITING. Twenty-six states and the District of Columbia have some type of limit, or cap, on charter school growth. Most caps restrict the number of charter schools allowed, while others restrict the number of students that a single school can serve. Such caps are often the consequence of political trade-offs, and not the result of agreement on sound education policy. Meanwhile, an estimated 365,000 students are on charter school wait lists—enough to fill over 1,100 new average-sized charter schools, and more than half of all charter schools across the country report they have a waiting list—a sure risk reducer for investors.

Source: www.publiccharters.org

public school students attend nearly 5,000 public charter schools in 40 states and the District of Columbia. In a 2008 Center for Education Reform survey of charter schools, 59 percent reported that they had a waiting list, averaging 198 students; the National Alliance for Public Charter Schools estimates that nationally, 365,000 students are currently on charter school wait lists. Caps continue to come off at the urging of the Obama administration and key governors across the nation, continue to come off. CMO and EMO growth is naturally accelerating in sophistication. An increase in the availability of capital will act to further fuel growth.

AREAS OF RISK. While the industry is currently fragmented, the overall market trajectory is one of growth. This is a sector that we see investors increasingly monitoring and participating in. Those investors should be focused on four major categories of risk:

1. Political. Although the market is far from saturated, demand from parents outweighs

While the industry is currently fragmented, the overall market trajectory is one of growth.

supply and politicians have pronounced bipartisan support for further continued charter school growth. If charter schools plateau on poor management, undercapitalization and mediocre facilities, they might lose the political support they have so far enjoyed.

2. Funding levels. In public education every new funding cycle is a fight for dollars; future funding levels are subject to flux. Currently, with levels at unprecedented lows in the wake of the Great Recession of 2007-2010, the trend will most likely be upward. Local, state and federal funding nonetheless remains limited and to some degree, unreliable. Walton Family Foundation, The Bill and Melinda Gates Foundation and other large donors certainly have widespread influence, but the enormity of the U.S. school system and the public demand makes such efforts look like seed money.

3. Fragmentation. Growth without necessary industry supports can pose a formidable challenge. If charter schools develop without contact with each other, without experienced multi-campus operators, and without coordination of proven and reliable modes of instruction, then growth will be slow and student performance may plateau. The risks associated with charter schools continue to diminish over time and are less evident in regions where adequate human and social capital is committed to create, authorize, grow and improve charter schools.

4. Quality. Certain groups of charter schools have done unusually well, and past reports have been largely positive, but a sobering study from the Center for Research on Education Outcomes at

Stanford University conducted in 2009 found that of U.S. students attending charters (70 percent were surveyed), 17 percent reported academic gains significantly better than those in traditional public schools, 46 percent showed no difference and 37 percent were significantly worse when matched demographically to their nearby public school counterparts.

As authorizers tighten qualifications, charter school closure is rare. Such closures are attributable to the financial instability that results from poor governance and declining enrollment, rather than from charter revocations, *per se*. The quality conversation is intensifying, but despite the problems in some schools, surveys reveal consistently high student, parent and teacher satisfaction with their own charter schools. Waiting lists are a good indicator of a low-risk school.

We expect to see an uptick in charter school closures by authorizers for academic performance. However, this will generally only effect the charter schools whose academic performance misses federal and state benchmarks over a period of 3-5 years. Overall, charter schools are growing at a healthy, rapid and consistent pace. For example, New Jersey is ramping up fast with 23 new charter schools approved and set to open in 2011 and 2012.

■ ***Evolution from a Movement to Industry***

- **Brief history.**
- **States progress and fragmentation level.**
- **Governance and regulation.**
- **Evolving industry supports.**

BRIEF HISTORY. Ray Budde, a University of Massachusetts Amherst professor originated the

idea of charter schools in a 1974 paper, "*Education by Charter*," though his proposal drew no response. In 1983, the *A Nation at Risk* report caused politicians and educators to focus on restructuring education, so Budde republished his paper in early 1988. A few months later, he was surprised to see in the *New York Times* that AFT leader Al Shanker had endorsed his idea. In fact, Shanker had told the National Press Club some time earlier that Ray Budde had the best name for these sorts of schools: *charter* schools. In the fall of 1988, state legislators in Minnesota were the first to draft legislation paving the way for such schools; by 1991, they had passed a law, followed by California in 1992, and six other states by 1993. From a few hundred schools only a decade ago, to the 5,000 charter schools currently spread out across the nation, charter schools are not going away.

STATES PROGRESS AND FRAGMENTATION LEVEL.

Each state is evolving differently. California parents praise their charter schools; a recent study indicates that an overwhelming majority give their child's charter school an "A". It follows that California charter schools saw their most significant increase, with 115 new charter schools opened in 2010-2011, the highest one-year growth in charter school history. After New York state lifted their cap from 200 to 400 schools, 25 new charter schools opened in 2009-2010, a 21.7 percent growth rate. In New Jersey, 23 new charter schools were approved to open in 2011 and 2012, adding about a third more to the existing 73. Texas recently started a strong association headed up by former Bush administration chief of staff Margaret Spellings. Still, many states are very new to the industry; 11 have yet to enact any charter school laws at all; still others are just beginning to come of age. The overall trend is widely varied growth attributable to state laws (40 states and Washington, D.C., actually have laws; states with no charter laws

include: Washington, Montana, North and South Dakota, Nebraska, Alabama, Kentucky, West Virginia, Vermont and Maine), with pockets of rapidly-increasing industry sophistication.

EVOLVING INDUSTRY SUPPORTS. The primary support for the charter industry comes from the National Alliance for Public Charter Schools and state-level associations. Most support organizations are focused on political advocacy but are building capabilities to provide technical assistance to their member charter schools. Technical assistance that each state association provides varies tremendously. Some of the types of technical assistance provided includes; startup-team training, new school incubation, various workshops, limited financing products, insurance products, group purchasing, public relations, and in a few cases back-office services. Schools who belong to charter management organizations or education management organizations tend to get most of their support from the CMO/EMOs. The National Association of Charter School Authorizers (NACSA) offers strategic planning, evaluation, implementation and growth services, professional development and policy guides and other supports in addition to setting standards for charter school authorizers. These and many other evolving industry supports from foundations, governments, associations, support organizations and management organizations over the last several years have worked to strengthen this sector substantially and have worked to decrease industry fragmentation. Most of these organizations are relatively new and were formed within the past 3-5 years with a few older than 7. Most of these groups were funded by major national education foundations including the Walton Family Foundation, and Bill & Melinda Gates Foundation. Besides professional associations, other support organizations have emerged including regional collaborative for various services, insurance

pools, back office providers, and facilities financing pools.

■ ***How Do Charter Schools Perform?***

- **Failure rates.**
- **Academic performance measures.**
- **Pressure for quality from authorizers and foundations.**

FAILURE RATES. In 2005, the Ewing Marion Kauffman Foundation presented some key findings that still resonate within the charter school industry. They warned lenders and investors of misleading data on charter school closings, where widely-used figures had not taken into account real estate issues. For example, one commonly cited survey appears to show that nearly one in ten charter schools had "closed"—in truth, the schools counted included many that had merely changed organizational structure and had continued to occupy and pay on their buildings. The Kauffman Foundation calculated that out of the 12 percent that reportedly closed, only half of these were true closures.

ACADEMIC PERFORMANCE MEASURES. As the charter school industry has advanced, focus has shifted from the quantity of new schools open toward the quality of those schools. Parents, teachers, state legislators and national leaders who cherish the flexibility that charter schools provide have started to emphasize quality as the first priority. Surveys on charter schools have consistently revealed high levels of satisfaction among students, parents and teachers regarding their charter schools, and whether or not they perform well on standardized tests, many of the schools that are not substantially outperforming traditional

public schools claim to have achieved their mission-related goals nonetheless. They also point to success in retention, graduation and college-acceptance rates, as well as lower rates of disciplinary incidents, and waiting lists.

PRESSURE FOR QUALITY FROM AUTHORIZERS AND FOUNDATIONS. With a failure rate of less than 6 percent, charter school closures remain very rare. The main reasons for their closure are always predictable, the usual reason is financial. Low enrollment, governance problems and poor finances all contribute. With increased pressure from authorizers and foundations for quality performance, only the bottom 10 percent or less are in any real danger of closing. If a school closes, it will be more for financial reasons led by declining enrollment.

■ **Financial Performance & Stability**

- **Sources and stability of revenue.**
- **Major costs and proportions.**
- **Primary drivers to a balanced budget.**
- **Key sources of financial risk.**

SOURCES AND STABILITY OF REVENUE. A key datum is that charter schools have very predictable and stable sources of revenue. They are largely calculated on average daily attendance rates. Charter school revenue is very stable and predictable because per pupil dollars, though this varies by state. For example, California charter schools averaged \$7,034 per pupil; New Jersey, \$9,579; while Utah averaged just \$4,907.

MAJOR COSTS AND PROPORTIONS. Roughly, cost breakdowns as a percentage of revenue include: 60 percent personnel; 15 percent facilities, 15 percent technology, books and supplies. Actual

Charter schools have stable revenue streams plus higher flexibility over regular schools.

costs vary tremendously depending on school model and class sizes. The biggest cost is personnel, which is driven by class size. The rest breaks down between facilities and size. Overall, costs and proportions vary significantly; class sizes and schedules drive what is needed.

PRIMARY DRIVERS TO A BALANCED BUDGET. The primary drivers are growing and/or stable enrollment and good financial management. Compared with other sectors, the charter school sector is of particular interest as it provides the best stable revenue streams. If they can fill a seat, they are guaranteed the revenue.

KEY SOURCES OF FINANCIAL RISK. Key sources of financial risk are enrollment, funding fluctuations of state, federal sources and an over-reliance on philanthropy. A notable cash flow risk is any delay in state per pupil funds but while sometimes late, they eventually do arrive.

■ **Facilities Challenge & Opportunity**

- **Access/sources of facilities.**
- **Limited capital sources, facilities capacity.**
- **Impact of capital constraints on growth, quality.**
- **Industry sophistication, fragmentation challenge.**
- **Opportunity for development groups.**

ACCESS/SOURCES OF FACILITIES. Rarely is a vacant school building available in good

condition or in a suitable location. Often, a space must either be adapted or upgraded, renovated to current standards, which adds to the expense. Some charter schools have benefactors to help pay for a facility or even donate one, but most—especially in lower-income areas—do not.

Charter schools have found mixed success with facilities and the procurement patchwork includes rented commercial spaces, storefronts, old school buildings and even church options. In areas with substantial proportions of charters, such elements have been the low-hanging fruit—much of it already picked by enthusiastic educators.

Meanwhile, access to predictable capital for facilities is varied. Only a few states offer additional funding for facilities or access to former public school facilities. Bond funding is elusive to the majority and only captured by a very few seasoned schools. Commercial bank loans also are of limited availability. Money from foundations, states and federal funding has built some capacity through loan guarantee and credit enhancement funds.

LIMITED CAPITAL SOURCES AND LIMITED CAPACITY FOR FACILITIES. Schools have coped with facilities needs by growing in stages. They might begin with a K-2 school, with a planned expansion to K-5 or K-8 after the second or third year. While this minimizes capital costs at startup, repeated moves to accommodate growth is inefficient, de-stabilizing and ultimately incurs additional costs. Lacking financial sophistication, long-term lease or mortgage arrangements and/or full-sized facilities continue to remain elusive for the vast majority of charter schools.

THE IMPACT OF CAPITAL CONSTRAINTS ON GROWTH AND QUALITY. Low-cost, charity-rate loans and mortgages for large amounts are

There remains a major opportunity in the charter school sector for a turnkey capital solution to the facilities issue.

scarce. On the conventional market, charter schools more often encounter additional charges rather than discounts. Dealing with an unfamiliar, non-traditional applicant, lenders and landlords attempt to cover the perceived risk by asking for extra loan guarantees, security deposits, and/or premium rates, effectively shutting schools out of the market or keeping them in less than ideal facilities or ones that put a halt to any further growth.

INDUSTRY SOPHISTICATION, FRAGMENTATION CHALLENGE. A few nimble nonprofits and public agencies have begun loan-guarantee funds to assist in meeting lender requirements. While some efforts have proved useful, one sponsored by the Department of Education, no less—in a study by the Kauffman Foundation, the "perceived risk" levels seemed unusually high, largely due to funding disadvantages. As a result, according to the Kauffman Foundation, "lenders and landlords could be missing out on deals that could have been made, by trying to cover more risk than they actually faced," and, "many well-conceived charter schools were missing out on buildings they could have paid for, if the bar were not set too high. Further study has indicated that this may indeed be the case."

OPPORTUNITY FOR DEVELOPMENT GROUPS. There remains a major opportunity in the charter school sector for a turnkey capital solution to the facilities issue; first-come financiers will enjoy a rather sizable share of the market should others continue to remain asleep.

■ **Conclusion**

Since this is an evolving industry, investors who understand how this market is maturing will be able to take advantage of the opportunities. With a new market in various stages of development, the savvy investor will be keen to the risks and barriers, but with some patience and a willingness to learn and understand this sector, they will be dealing with schools who are very solid operators—who will not be going away—and who have extremely stable revenue streams that can be well-managed over time and that are more predictable than many other sectors. //

Extra Reading:

http://www.lisc.org/docs/resources/effc/2010CSFLandscape_r.pdf

<http://www.publiccharters.org/aboutschools>

http://almafhpc.com/www/uploads/pdf/resource_20081103111240_Good%20to%20Gone.pdf

<http://sites.kauffman.org/pdf/CharterSchools071805E.pdf>

"...That leads me to the fourth part of America's education strategy – promoting innovation and excellence in America's schools. One of the places where much of that innovation occurs is in our most effective charter schools... Right now, there are caps on how many charter schools are allowed in some states, no matter how well they are preparing our students. That isn't good for our children, our economy, or our country. Of course, any expansion of charter schools must not result in the spread of mediocrity, but in the advancement of excellence. That will require states adopting both a rigorous selection and review process to ensure that a charter school's autonomy is coupled with greater accountability – as well as a strategy, like the one in Chicago, to close charter schools that are not working. Provided this greater accountability, I call on states to reform their charter rules, and lift caps on the number of allowable charter schools, wherever such caps are in place."

—President Obama, March 10, 2009

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