

## U.S. Municipal High Yield Market

# Stable Outlook for Charter Schools into 2024

HilltopSecurities has a stable outlook for charter schools as we look forward to 2024. This outlook reflects the relative maturation of the sector that now educates more than 3.7 million students in almost 8,000 campuses across the United States. Despite our stable outlook, we recognize that there are some headwinds reflecting capital and operational pressures that the schools will face over the medium term. This outlook explains these pressures as well as underscores the critical importance to focus on management and demographics to help navigate the turbulence and identify attractive charter school investment opportunities.

## Capital Pressures

On the capital side there are four specific risks:

- Ability to access the capital markets,
- Cost of the borrowing,
- Increasing project costs, and
- The impact of higher debt service on the actual operating budget.

Annual charter school issuance has declined by approximately 50% year over year from approximately \$4.8 billion in 2022 to under \$2 billion year to date 2023. This is not because we have solved the capital needs for the over 3.5 million students that attend charters at almost 8,000 campuses; rather, it reflects the fact that cost of capital has increased squeezing the affordability of the project, and investor demand is a bit softer reflecting mutual fund outflows which have exceeded \$11.8 billion this year according to Lipper data – although high yield municipal flows year to date have been slightly positive.

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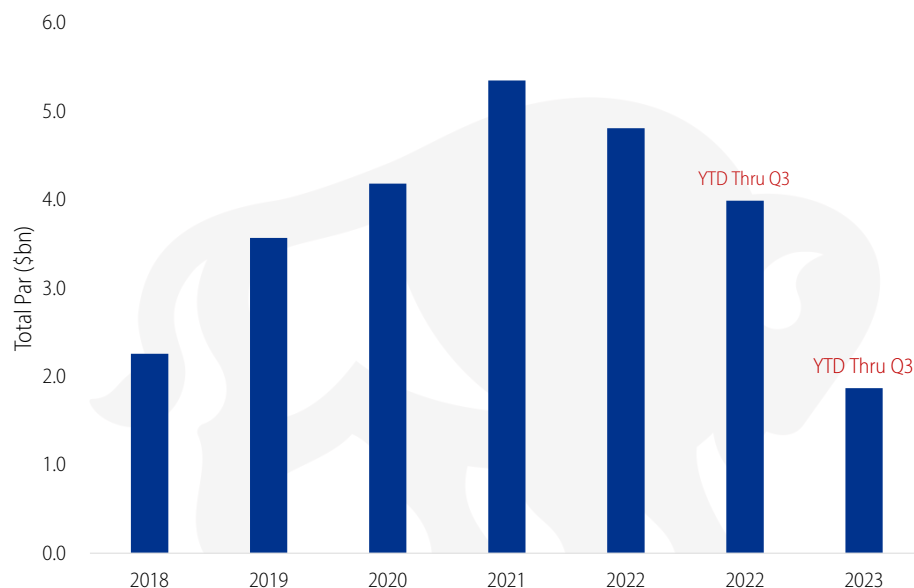
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## Annual Charter School Issuance



Source: Bloomberg and HilltopSecurities.

In addition, we have heard anecdotally from our issuer clients that the general cost of construction has not been immune to overall inflationary pressures and has been reported to have increased by approximately 40% over the last year and a half. Taken together, higher construction costs and higher capital costs have challenged the charter schools to deliver high quality capital assets that fit within tightly budgeted financial operations.

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The chart below depicts how average yields have changed from their trough in 2021 to their peaks in 2023. In the rated space, schools in states including Texas, Colorado, Arizona, Utah and Idaho benefit from state enhancement program. This chart adjusts for the state enhancement programs, such as the AAA Texas PSF guaranty and the AA range program enhancements in other states, and shows average costs of capital for rated, unenhanced charter schools. By focusing on the purple line, one can see that in 2021, a BBB charter school would have been able to access the capital markets with their respective long bonds priced to yield approximately 3%. Today that same credit would fund at approximately 6%. Similarly, in the non rated space, a charter school may have been able to issue debt 4% in 2021. Today, the cost of non rated charter school debt can approximate 7%.

### Charter School Yields, 2018 to Current



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Source: Bloomberg and HilltopSecurities.

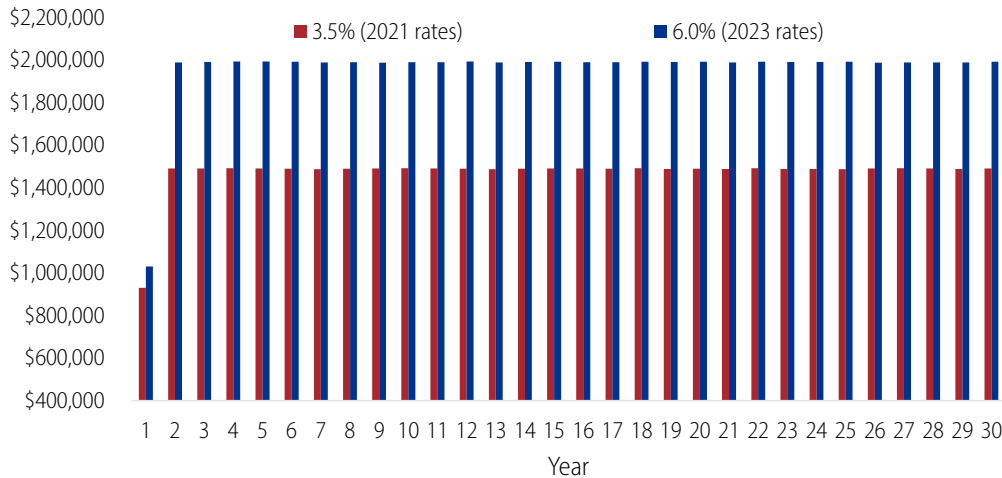
S&P Global Ratings reports that a typical BBB- charter school has the following median fundamentals:

- Operating revenues of \$16.0 million
- DCOH of 173
- Cash to debt of 37.5%
- Lease-adjusted MADS of \$1.354mm
- Lease-adjusted MADS burden of 8.8%
- Lease-adjusted MADS DSC of 1.9x
- Average deal size of \$27.4 million

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As a result, if you take a \$27.4 million transaction, allow for one year of interest only prior to amortizing the debt, and price the 30-year bond at 3.5% and then price the 30-year bond at 6%, debt service will increase more than 40% from approximately \$1.4 million to \$2 million.

## Annual P&I on \$27.5MM Over 30 Years



Source: HilltopSecurities.

Given the higher debt service costs in this sample case, debt service coverage would decline from a satisfactory 1.37x to an extremely narrow 1.00x and the percentage of the budget used to fund debt service would increase from 10% to over 13%. Given that charter school budgets are already tightly balanced to cover growing teacher salaries and other expenses, this increase results in fewer available dollars to fund other school priorities.

## Debt Service Costs

	3.5% Cost of Capital	6.0% Cost of Capital
Lease Adjusted MADS DSC (x)	1.37x	1.00x
Pct. of Budget for Debt Service	10.0%	13.3%

Source: HilltopSecurities.

Despite these pressures, charter schools remain a very investable space within the high yield sector. Charter schools provide an essential service in providing an alternative path of education with studies showing that the average child in an urban and suburban school has made greater math and reading progress than their peers in traditional charter schools according to the Center for Research on Educational Outcomes at Stanford University.

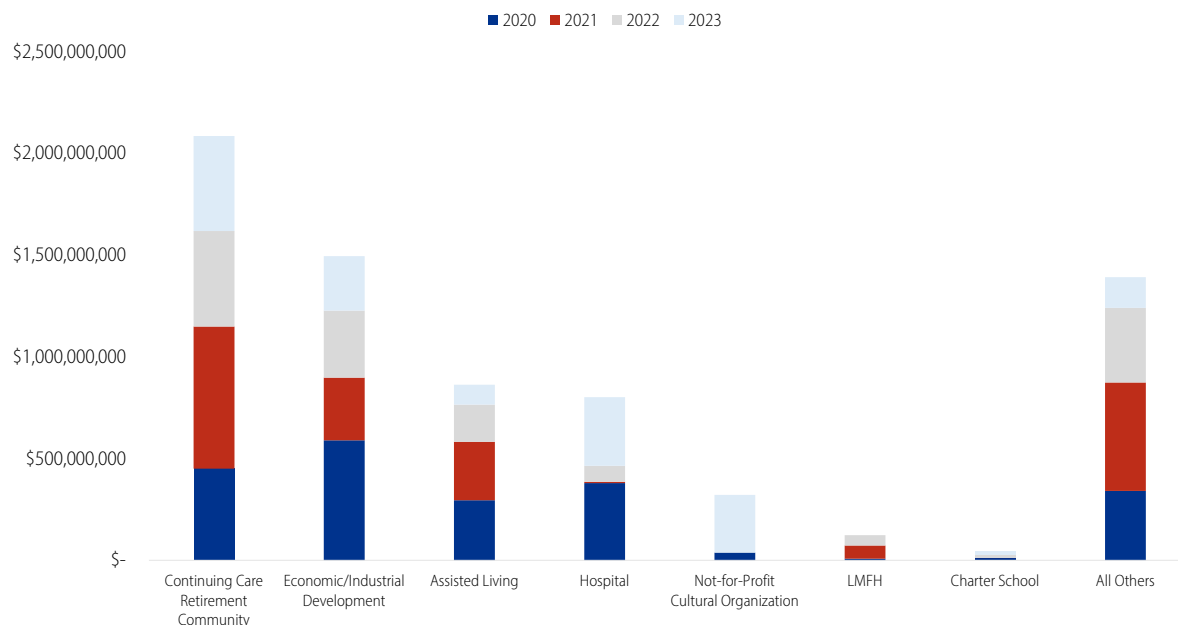
According to data from Municipal Market Advisors, there was a total of 1,233 issuers with monetary defaults between 2009 and 2023. Of which, 82 or 6.6% were charter schools. However, as the size of these transactions, as compared to senior living and project finance transactions tends to be small, and there tends to be less default activity in the larger charter school systems, the actual contribution of charter school to municipal monetary defaults is less than 5% in number. In addition, with respect to dollar volume of defaults, according to 2023 Bloomberg data, the three charter school defaults accounted for 1% of monetary losses in the municipal sector year to date.

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## Monetary Default



Source: Bloomberg and HilltopSecurities.

It is similarly important to point out, that the number of charter school technical defaults, reflecting debt service coverage or days cash on hand below covenanted levels have increased recognizing the challenging operating environment. These technical defaults do not need to progress to monetary defaults, if management works proactively with authorizers and outside consultants to improve academic results, attract and retain students, and maintain fiscal discipline.

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## Operational Challenges

In addition to the capital challenges that schools are facing, charter schools and charter school investors need to be focused on several key operating risks as they relate to revenue growth, inflationary pressures and governance. One key area of focus is on stated aid revenues as state aid per pupil funding is the largest source of charter school revenues.

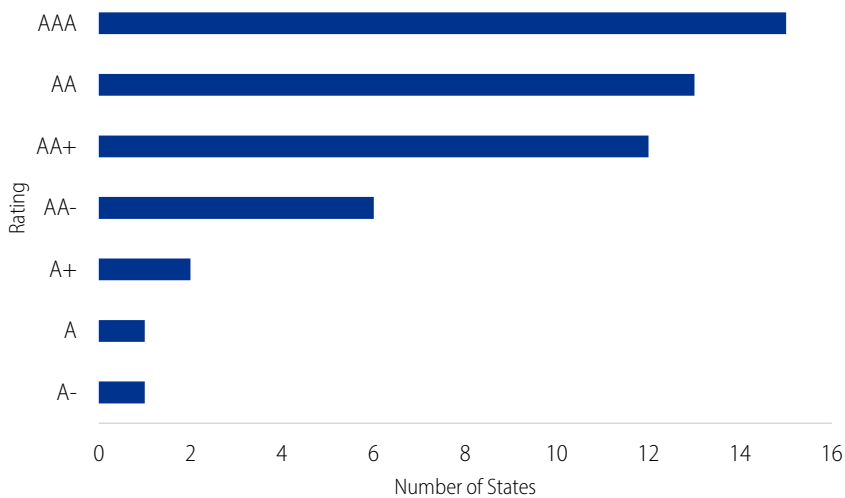
### Pressure on state aid revenues

- Will annual increases in state revenues cover growing costs?
- Will liquidity be affected?

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## State Ratings Distribution, as of Sept. 22, 2023



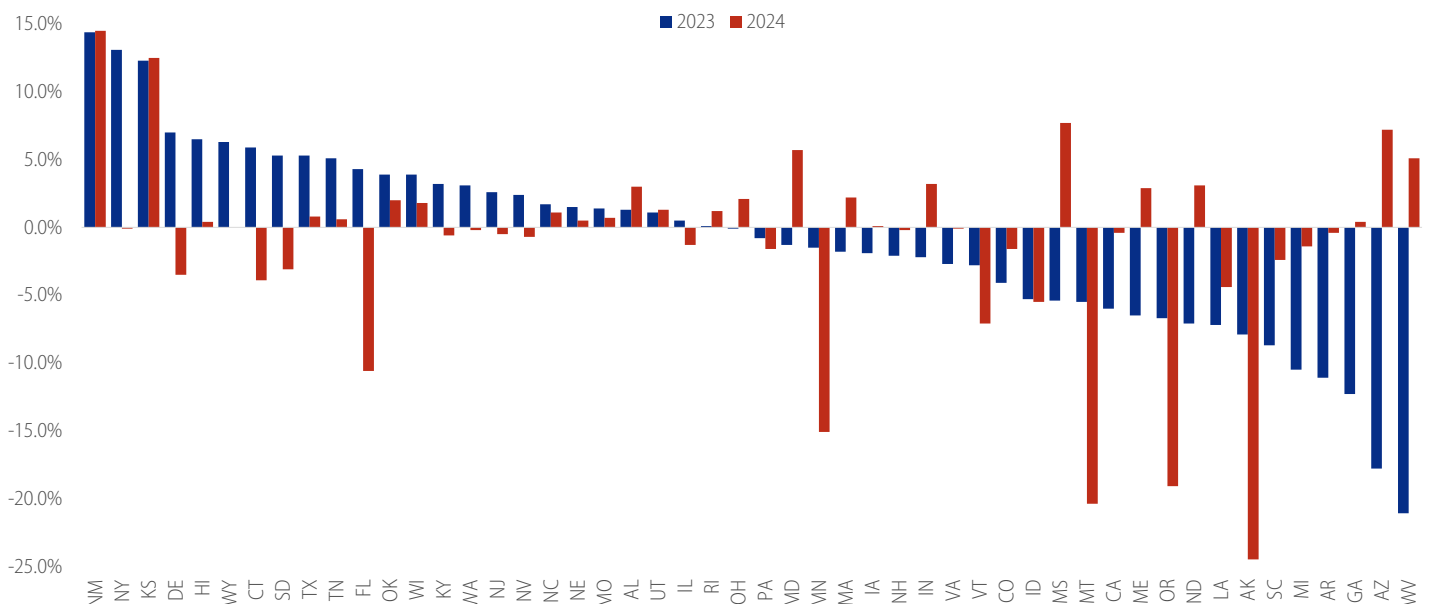
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Source: S&P Global Ratings.

Although states have benefited from significant growth in their primary tax revenues including income and sales taxes as well as federal funding, some states are beginning to experience flatter or even declining revenues. According to Moody's Investor Service, median tax revenues are likely to slow to low single digits. As a result, HilltopSecurities points to a potential charter school vulnerability as states with slowing growth in primary revenues may choose to slow incremental per-pupil revenue growth to charter schools as they seek to balance their own budgets. In fact, Moody's revised the outlook on California's rating to Aa2 negative given the 2023 revenue decline. The potential impact of this observation will vary by state, and it is important to stay aware of individual state trends.

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## Annual Change in General Fund Revenue by Year



Source: NASBO and HilltopSecurities.

### Pressure on expenses

- Will perpetuation of labor shortages continue to pressure wage costs?
- Will proliferation of strikes and unions affect operational flexibility of schools?
- Other cost pressures:
  - Health & safety
  - Campus security
  - Energy

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### Pressure on enrollment

- Competition for students remains for charter schools in highly concentrated areas
- Can charters attain and retain enrollment projections?
- Impact of demographic changes

Although charter school enrollment continues to increase and stands at over 3.7 million according to the National Alliance of Public Charter Schools, the competition for students can be intense particularly in areas in which student enrollment is flat to declining. Charter schools have closed for a myriad of reasons including low enrollment, fiscal mismanagement, violations of charter and school contract requirements. Each of these issues can affect the others and can create a cycle to closure or a path to success depending on whether a charter school management team is willing to work collaboratively with authorizers and third party consultants to attain and retain students and withstand impacts from negative area demographic changes or increasing competition in the area.

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### Governance

- Continued focus on recurring structural balance and maintaining ample liquidity
- Preparations to combat cybersecurity
- Charter renewal risk

Fiscal health remains critical for long term charter school sustainability and reauthorization of charter school contracts. Given the probable likelihood that annual per-pupil revenue growth may not keep pace with operational and capital needs, charter school management teams will be forced to prioritize spending. Academic success is the other most significant ingredient to charter school growth and management will need to continue prioritization to its central mission. Never has management been more important to the continued success of each charter school and the continued attractiveness of a charter school investment.

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## Stable outlook into 2024

Charter schools as a sector have matured since their initial debut thirty years ago and will remain an important component of U.S. based education options. There are 45 states with charter school laws and close to 8% of U.S. public school students attend a charter school. In fact, California is the state with the most charter school students (700,000), 20% of school aged children in Arizona attend a charter school, and over 99% of students in New Orleans attend a charter school. Despite the importance of charter schools, the inflationary environment coupled with the increased costs of capital coupled with the increased cost of construction, will continue to challenge leadership teams to provide optimal education in safe and attractive capital assets. In addition, management will need to remain vigilant to ensure they maintain academic results, as well as appropriate levels of liquidity and debt service coverage while ensuring compliance with charter school governance requirements.

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