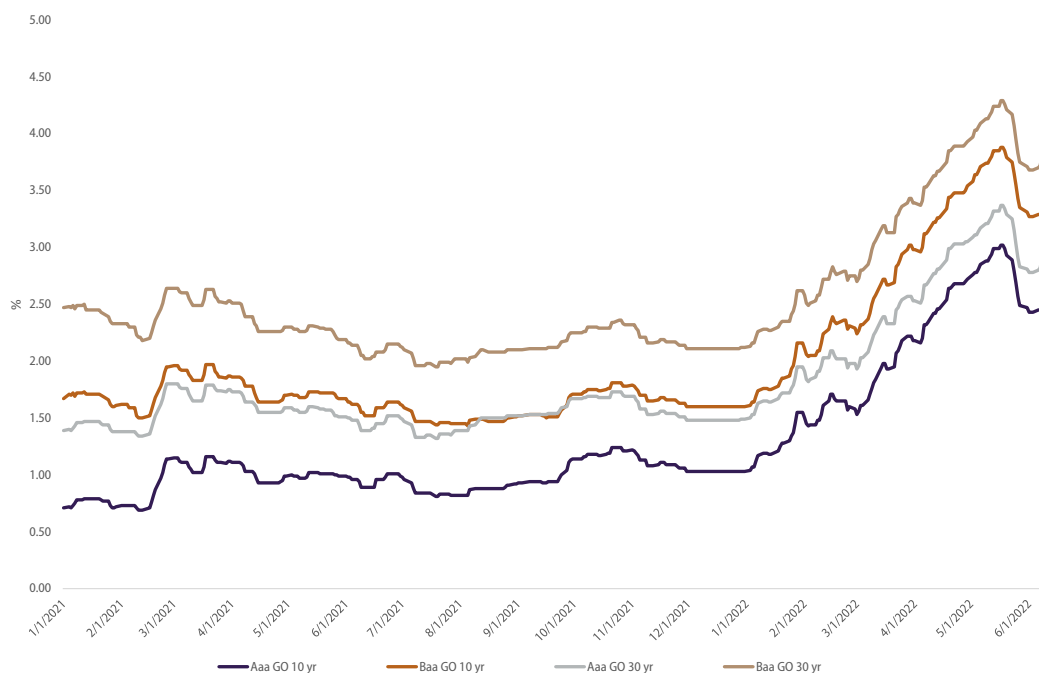


Charter Schools ... Bucking the 2022 Trend?

Investors have identified charter schools as a sector that they are relatively less concerned about when compared to other high yield sectors and a sector to which they are interested in adding exposure in the [Hilltop High Yield 2022](#) and [2021 Surveys](#). Some investors see charter schools as recession proof as the charters are tuition free for parents, and funding, predominantly state aid, is typically determined by enrollment which has been growing. This is not to say that states in the past have not reduced funding at the charter school level to meet budgetary needs which can impair credit quality. However, at this point, state coffers are generally robust, having benefitted from federal covid relief aid and generally positive revenues associated with income taxes and sales tax revenues adding to the expectation of medium term stability for the charter school sector.

Despite investor receptivity for charter school debt, the financial markets in 2022 have experienced significant volatility which has altered pricing and rendered it more expensive and far more difficult to successfully complete financings. To date, we have seen yields on tax exempt senior project finance bonds exceed 10% and we have seen transactions in the Project Finance, Senior Living, Higher Education and even Charter School sectors that have not been completed. This article compares charter school issuance between the first five months of 2022 and 2021 to determine what trends can be isolated year to date given market volatility and negative fund flows which has significantly increased the cost of capital.

MMD Since Jan. 1, 2021



Yaffa Rattner

Head of Municipal Credit
Senior Managing Director
214.859.9883
Yaffa.Rattner@hilltopsecurities.com

John Pellicci

Head of Municipal Underwriting & Sales
Senior Managing Director
612.439.6110
John.Pellicci@hilltopsecurities.com

Analytic Support

Ted Chapman

Investment Banking Analyst
214.859.1067
Ted.Chapman@hilltopsecurities.com

Cal Hoss

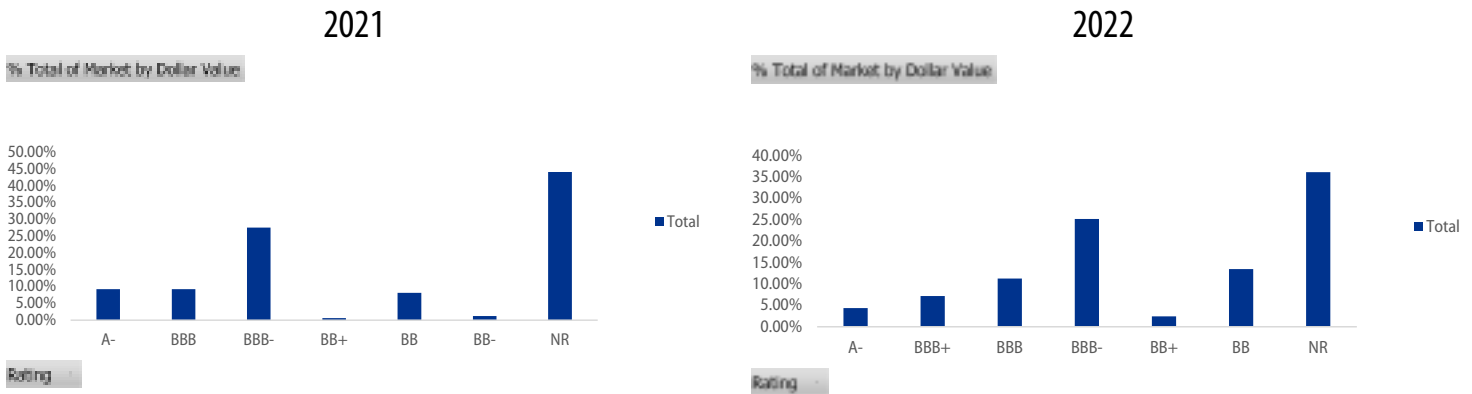
Fixed Income Capital Markets Intern
214.953.4040
Cal.Hoss@hilltopsecurities.com

What is a charter school?

Charter schools are public schools supported primarily by state funding that operate under a charter between an authorizer (such as a state agency, school district, or not profit organization) and the charter school that hold the school accountable for academic progress, financial stability, and governance mandates. As such, charter schools have more flexibility to design curriculum and structure to propel their students to academic success. When schools fail to comply with their charter school requirements, their charters can be revoked resulting in an average 3.5% of annual charter school closures with a 4.2% closure rate for charters in their first year of operations. According to the National Alliance for Charter Schools, 69% of closures reflect poor academic performance, low enrollment, or financial pressures. There are approximately 7,700 charter schools in the United States with 3.5 million students enrolled accounting for approximately 7.2% of public school children. (publiccharters.org)

Between January 1st 2021 and June 10th 2021, a total of \$1.86 billion of charter school debt was issued compared to \$2.18 billion issued in the same period in 2022. The market in 2022 is characterized by more significant rating penetration at 65% of the market which makes sense given current market fundamentals which are supportive of credits that present less risk.

Percent Total of Market Dollar Value

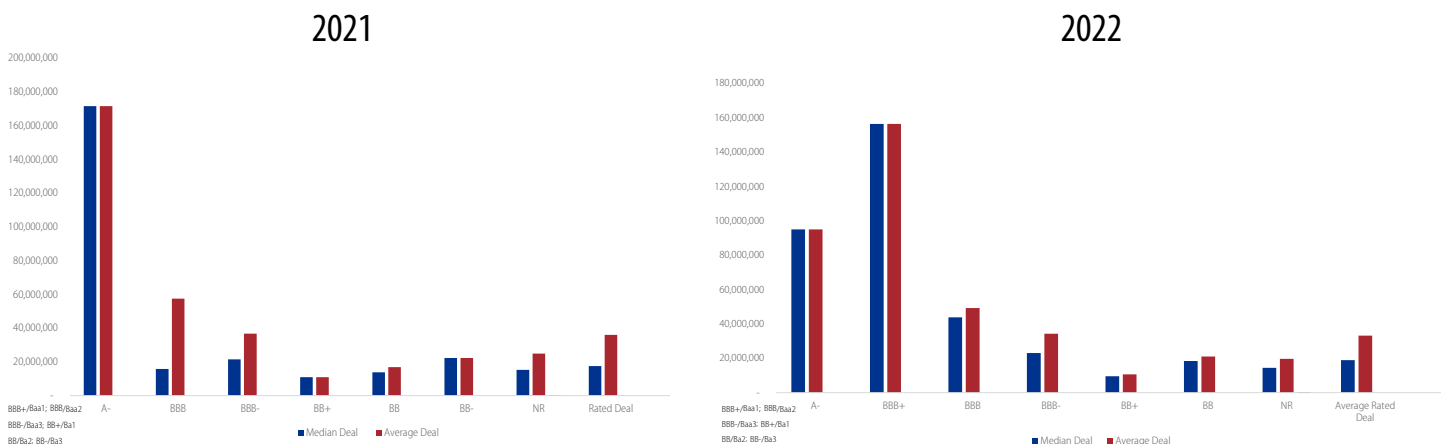


Ratings from Standard and Poor's and Moody's Investors Service are incorporated to the rating distribution on all charts.

The average rated deal size in 2022 was \$33 million compared to \$36 million in 2021. The average non-rated deal was \$19.7 million in 2022 and a higher \$25 million in 2021, reflective of the change in investor sentiment. Standard and Poor's has the predominant market share with more than 300 charter school ratings while Moody's Investors Service rates approximately 100 charter schools.

Nonrated deals accounted for 35% of 2022 new issuance volume vs 45% of 2021 new issuance volume through the beginning of June. On average the non-rated deals year to date 2022 were smaller than in 2021 at \$14.39 million vs \$15.3 million in 2021. Based on discussions with market participants, the decline in nonrated volume vs rated issuance likely reflects that certain charter schools, simply cannot afford the new cost of capital and generate the level of debt service coverage needed for a successful investment as well as the fact that other charter schools need more seasoning, typically liquidity, students, or charter renewal progress, in order to clear in the 2022 market.

Average & Median Deal Size

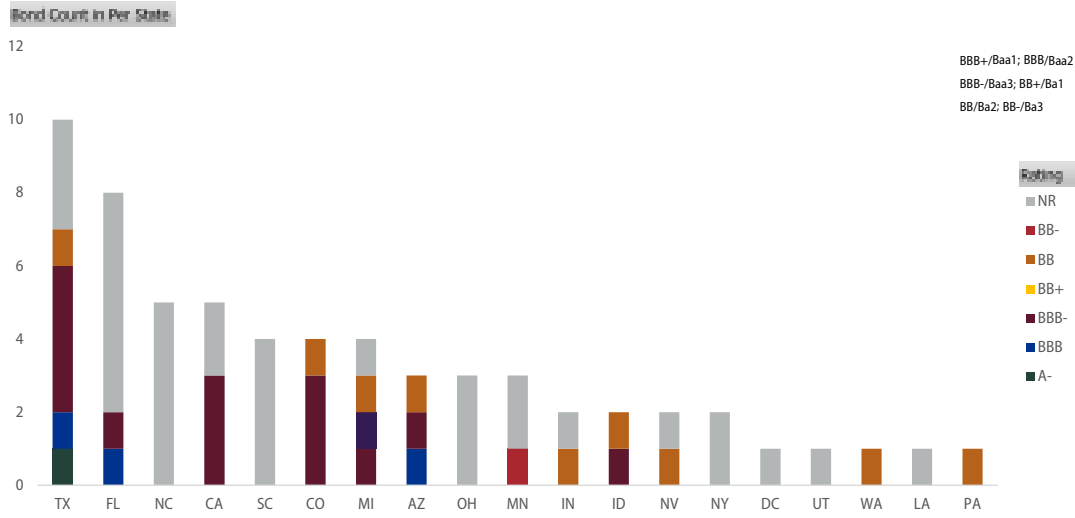


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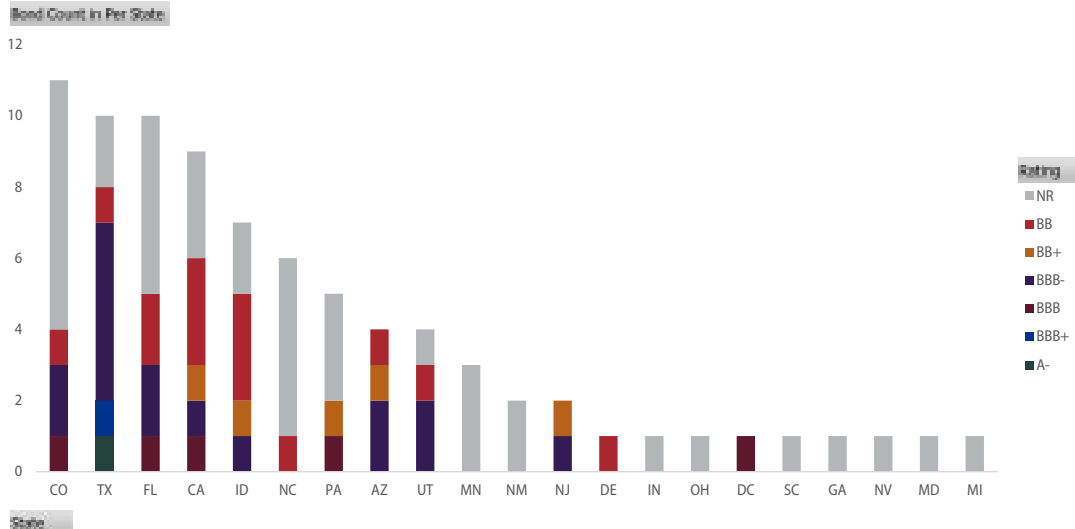
Year to date we have seen significant issuance in states, including Colorado, Texas, Florida, and California compared to 2021 in which Texas, Florida, North Carolina, and California took the top spots. with the largest charter enrollments and numbers of facilities. Of note, is Idaho issuance in 2022 with 7 deals and total par of \$65 million. Moody's rated 8 deals in 2021 with a median rating of Baa3 while they rated 14 deals in 2022 year to date with a median rating of Ba2. Moody's ratings in Idaho increased to 5 year to date (from 1 in 2021) in 2022, assisted by the presence of the Moody's Aa2 rated State Moral Obligation Enhancement Program. Also interesting are the North Carolina charters which issued 5 non rated deals, through the Wisconsin Public Finance Authority, with a total volume of \$66 million. However, no deals have been issued year to date in 2022.

Bond Count Per State

2021



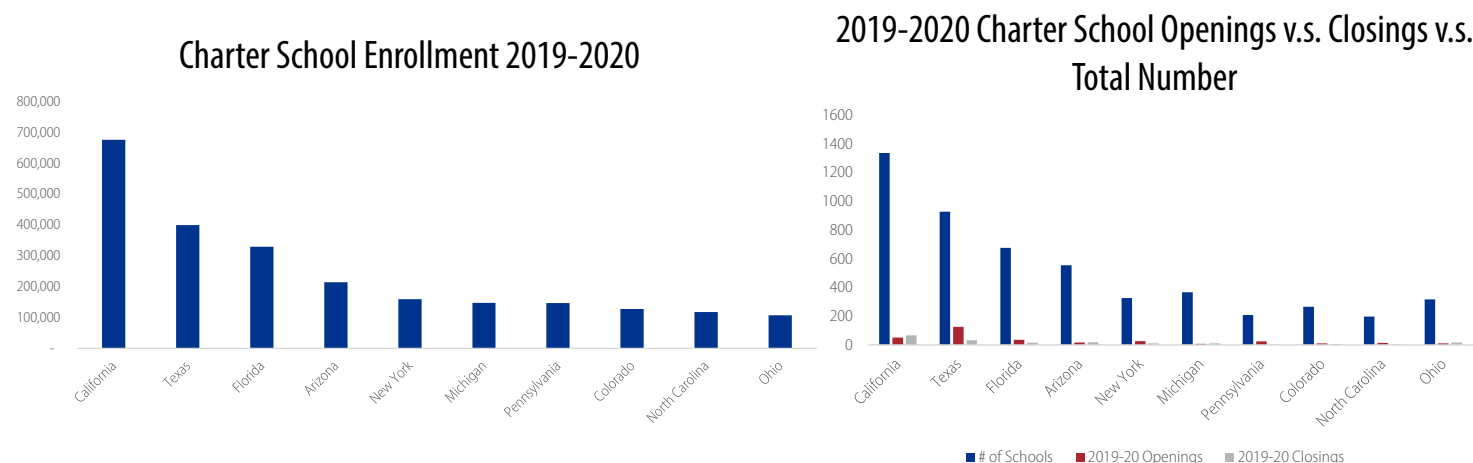
2022



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Charter School Enrollment

Nationwide, California accounts for the largest number of charter schools and charter school enrollment with Texas, Florida, Arizona, and New York rounding out the top 5 states. Arizona, is the state with the largest % of its population attending charter schools at almost 19%. Florida and California each have at least 11% of their public-school students attending charters.



When evaluating rating penetration, by state, it is interesting to note that in 2022, Texas has the greatest number of new issue ratings with a median rating of BBB- followed by California with a median rating of BB+ corresponding to the S&P median rating information that shows Texas with 33 rated credits and California with a total of 38 S&P rated credits.

State	Median Rating	Number of rated credits	Enrollment	Unrestricted Days Cash on Hand	Unrestricted Cash to Debt
Arizona	BB+	25	1,188	101	16%
California	BB+	38	1,760	139	38%
Colorado	BBB-	26	850	177	30%
Florida	BBB-	14	1,578	186	35%
Michigan	BB	29	791	90	26%
Minnesota	BB+	28	730	129	21%
New York	BB+	14	928	237	67%
Pennsylvania	BB+	19	856	147	31%
Texas	BBB-	33	1,554	14	22%
Utah	BBB-	24	915	168	28%

Data from Standard and Poor's Fiscal 2021 Medians.

Cost of capital

The cost of capital in 2022 has created sticker shock for issuers this year resulting in a +200 basis to +250 basis point increase over 2021. As a result, credits that are more marginal, will struggle to meet debt service costs and maintain margins needed for investor receptivity. Take for example a BB+ rated charter school. In 2021, if they issued \$30 million in debt, their annual debt service cost would be \$1.631 million based on a 3.5% rate. In 2022, debt service on the same bond would approximate 5.5% generating debt service costs of \$2.064 million and proceeds would be reduced by \$433,000 as the deposit to the Debt Service Reserve Fund would need to increase. What does this mean? The issuer would have to fund debt service obligations that are more than 26% higher while generating fewer proceeds for their debt. If the school generated 1.7x debt service coverage in 2021, then their Net Operating Income (NOI) for Debt Service would be \$2.77 million. However, if the same NOI was generated, debt service coverage would only be 1.34x if the debt was sold in 2022. This 36 basis point differential in coverage is a gating issue that can differentiate a market accepted deal to a deal that cannot clear in the current environment.

Outlook

As charter schools continue to attract more students, increase their liquidity and debt service coverage, and produce strong academic outcome for their students, the sector performance will continue to improve. However, key to this expectation, is management's ability to manage through increasing salary and supply expenses and as well as increasing lease or debt service expenses. This outlook assumes no significant change at the legislative level that would significantly alter charter renewals which if introduced could introduce incremental risk into the sector. In addition, this expectation assumes that state per pupil funding will continue to increase, commensurate with inflationary pressures, and not be reduced over the medium term. It should be noted that if states begin to be impacted from a falloff in annual revenues, and negatively adjust charter school aid in total or in timing, charter school credit quality and receptivity in the market can be adversely affected. The schools' with ample revenues and debt service coverage are expected to perform well over the medium term.

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