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The U.S. Charter School Outlook Is Still Negative In 2014

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Charter schools -- publicly funded institutions that offer alternatives to traditional public schools -- operate in an inherently uncertain environment, with charters usually good for only about five years. Standard & Poor's Rating Services continues to view the charter school sector's credit quality outlook in 2014 as particularly volatile and trending negative. Fundamentally, charter schools are typically limited in terms of enterprise and financial flexibility, which constrains ratings and, in difficult times, presents a greater possibility of downgrades than for public or independent schools.

Despite growth in Standard & Poor's rated universe of public charter schools, problems persist, as the number of downgrades and negative outlooks assigned in 2013 shows. Although the general environment for charter schools is improving gradually, with exceptions that vary by state, we expect downgrades will continue to outpace upgrades in 2014.

Overview

- Despite overall growth and continued maturation of the sector, charter schools have limited flexibility to withstand difficult operating conditions, resulting in volatile rating activity.
- We believe the sector's credit quality will keep declining in 2014.

The range of risks facing the sector will likely result in continued uneven credit performance and a widening gap between stronger and weaker schools. Credit strength will largely depend on each school's specific characteristics and management's ability to respond effectively. Our negative outlook for the sector is due to a confluence of factors, including:

- The lingering effect of several years of funding decreases in certain states, leading to weaker-than-expected cash flow, shrinking operating margins, and lower maximum annual debt service coverage;
- Enrollment declines, sometimes with increased competition, which limits schools' ability to respond to changes in demand for their services;
- Academic concerns as state and national performance frameworks continue to evolve;
- Threats of charter revocation or limited renewal by authorizers; and
- Lack of management oversight combined with limited financial expertise, often leading to more frequent violation of bond covenants.

In addition, charter school legislation continues to evolve at various speeds in different states, adding to the complexity and volatility inherent in the sector.

We believe that many charter schools continue to navigate these headwinds effectively, and that generally improving state budgets and stabilizing per-pupil funding are positive trends. However, rapid credit deterioration has occurred with delinquent debt service payments, school closures, or charter revocation or nonrenewal. These negative trends are the result of weak academic performance, lack of financial oversight, or concerns regarding management and governance. Therefore, our ratings are beginning to reflect a greater emphasis on management expertise, particularly financial acumen; on maintenance of a healthy financial cushion; and on the demonstrated ability to weather challenges successfully. We also have a more skeptical view of management projections and less tolerance for weakening financial performance.

The Sector Is Inherently Unstable

The charter school sector is still very young relative to other public finance sectors, with the first charter schools opening in Minnesota in the 1990s. Consequently, while most public finance issuers have been operational for decades or even centuries, most of the charter schools we rate have been in existence for less than 20 years, and in a few cases as little as three years. Young charter school organizations typically present significant start-up risk, including ramp-up costs, unproven demand, and inexperienced or new management teams. Another problem is a lack of data available for trend analysis of economic or financial factors. In such cases, charter schools may provide budgets and projections to Standard & Poor's that sometimes lack supporting assumptions and that may or may not reconcile with the school's historical trends.

In addition, charter schools in growth mode may experience volatile operations or face unique challenges as they acquire, build, or lease new facilities, and as they add grade levels to accommodate students advancing from grade to grade. Finally, charter schools inherently lack revenue diversity and depend entirely on per-pupil revenue from local or state sources, which can fluctuate based on state budget levels and enrollment. All of these factors lead to greater uncertainty about financial performance and the potential for more volatile rating and outlook trends.

Reflecting this instability and the number of younger schools and new issuers, 2013 was a busy year for charter school ratings at Standard & Poor's. We added 36 new ratings, 20% growth in the number of charter schools we rate. In addition, we revised the outlook or changed the rating on another 50 charter schools, with negative actions significantly outnumbering positive. The growth and volatility of charter school ratings exceeds that of other public finance sectors that Standard & Poor's rates. We expect this to continue as the movement evolves and matures in various states, as new financing opportunities emerge, and as schools continue to access the capital markets to secure funding for facility needs. While growth can be a positive, at this pace it presents greater uncertainty and potential for rating changes, particularly given the sector's volatility.

The charter school sector is still recovering from the effects of state funding cuts and holdbacks in recent years that have resulted in declines in cash on hand and operating margins. This diminished funding greatly strained charter school budgets, having forced many schools to increase class sizes, cut staff, and, in some cases, eliminate programs. In addition, some schools engaged in short-term borrowing to address cash flow needs, which resulted in elevated costs and weakened credit profiles. In general, charter schools have not historically maintained sizable cash reserves, so any operating disruption from reduced or delayed funding, enrollment declines, or capital expansion has the potential to impair financial metrics quickly.

While we believe these factors will keep creating volatile and negative credit quality in the sector for the coming year, stabilizing factors are also at play. As state budgets have started to generally improve during the past year, per-pupil funding levels have either stabilized or increased from historic lows. As a result, we expect to see better operating margins and cash flow in fiscal 2013 and 2014 for schools that have maintained stable enrollment levels and manageable expense growth.

Risks And Opportunities In 2014

The charter school sector is ever-evolving, and we consider a multitude of factors in our credit analysis. We believe the following risks and opportunities will be particularly relevant for charter schools in the next year.

Lack of management depth and expertise

Despite continued growth in the charter school sector, many schools suffer from inexperienced leadership, particularly concerning financial and debt management practices. Often schools are started and run by a visionary leader or supportive group of parents, teachers, or others who wanted an alternative to traditional public school options. Likewise, schools often fill board seats with parents or local leaders who have great enthusiasm but limited skills for running a complex start-up business. As the number of schools we rate has increased, we have seen a growing disparity between strong and weak management teams. Given the sector's volatile nature, we anticipate that rating activity will largely reflect management's response to the credit risks a school faces. We expect that the schools with sufficient management breadth and depth will continue to develop effective strategies for responding to change while those that lack sufficient leadership will likely experience weakening credit profiles.

Charter authorization and renewal risk

As the sector matures, a second wave of legislation is emerging, some aimed at providing more equitable funding mechanisms and reducing competition between public school districts and charter schools by creating stronger authorizing entities that provide enhanced oversight. Charter authorizers in more states are taking steps to increase charter school accountability, including revoking charters and closing academically failing schools. While no charter school that we rate publicly has lost its charter to date, we are hearing about discussions concerning potential nonrenewal and authorizer notices of intent to revoke. In some cases, the mere threat of charter revocation has forced schools to rapidly change academic programs where performance is below charter standards, to strengthen leadership positions, or to cut expenses to bolster their financial positions. In other states, authorization has shifted away from local authorizers to nominally more independent state authorizers. Legislation in some states has extended the possible charter length although our observations indicate that actual authorization time remains generally consistent with historical authorization and renewal periods. We believe generally positive legislative activity will continue in 2014, opening up possibilities for charter schools to operate in new states or to make expanding operations easier through mechanisms such as replicating charters, lifting charter enrollment caps (following Texas' action in 2013), and lengthening possible renewal terms.

Academic performance will continue to stimulate demand

High academic performance is the key for charter schools to generate demand, distinguishing the institution from its competition. We view academic performance as a significant factor in the overall enterprise profile in that it indicates management's competence and the viability of the school's particular academic model. Strong academic performance does not always translate into strong financial management, but it does lead to rising demand and, consequently, revenue growth, providing a source of operating flexibility that we believe is beneficial. In 2014, however, we expect comparing academic performance through trend analysis will become more difficult as many states adopt new measurement standards or adjust to the Common Core benchmarks. As schools identify new benchmarks, we'll look for continued or growing academic strength relative to competitors.

Fluctuating demand and increasing competition

Local demographic changes can significantly affect demand for charter school services. Although they're present in a diverse set of state and regions, most are operating in urban environments with transient student populations. Most notably, the Detroit metro area has experienced significant economic hardships and population declines that have weakened demand for and enrollment at charter schools we rate in the area. This has increased competition as charter schools and public schools vie for a declining number of elementary- and secondary-school children. We expect this rivalry to continue in 2014, eroding wait lists and enrollment for some.

Financing opportunities evolve but are sometimes complex

The way charter schools are financed is also developing. Among the options are community development financial institutions, private lenders, and philanthropic organizations, as well as financing vehicles like new market tax credits and moral obligations that are often combined with traditional long-term debt. Each charter school bond financing is unique, and our ratings will continue to reflect each particular situation, as well as the volatility and cautious view we have of the sector overall.

As more charter schools access the debt markets, structures appear to have become more complex with a proliferation of building companies, single-purpose entities, and limited liability companies involved in issuing debt. We believe the market is paying closer attention to bond covenants and projected key financial metrics. Over the past two years, more technical covenant violations have occurred as schools struggle to meet covenants concerning debt service or days' cash on hand. While usually not an event of default in the first year, a continued inability to meet required levels of liquidity or other measures could result in acceleration of debt. We will continue to pay close attention not only to covenant violations, but also to the financial cushion a school maintains relative to covenanted levels. We expect to see additional violations and decreases in resources given the other problems facing the sector. Given the potential for immediate debt acceleration and the ability for credit quality to spiral down relatively quickly, if a charter school has little room before triggering covenant violations, we might not wait to take a negative rating action –- potentially by multiple notches.

Rating actions and outlooks are negative

The charter school sector tends to be increasingly volatile, with approximately one-third of our reviews having resulted in a rating or outlook change in 2013. As we forecasted (see "Funding Volatility May Cause Public Charter School Credit Quality To Deteriorate Further," published June 27, 2013, on RatingsDirect), the number of rating downgrades outpaced upgrades in the year, with 26 downgrades and no upgrades. Outlook changes were also overwhelmingly negative during 2013, with 26 negative outlook changes and five positive. Relative to rating activity in 2012, the number of downgrades increased by over 50%, and the number of negative outlook changes increased by over 150%. With six times as many negative outlooks as positive outlooks in the sector, we expect negative rating actions to keep outpacing positive actions in the next year or two.

Chart 1

Charter School Rating Distribution By Outlook

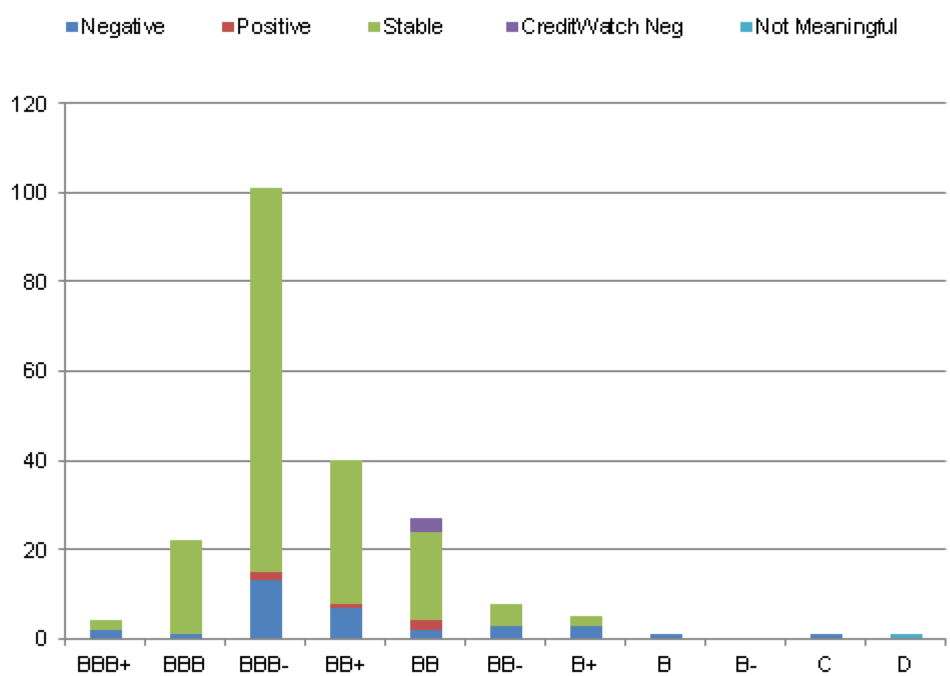
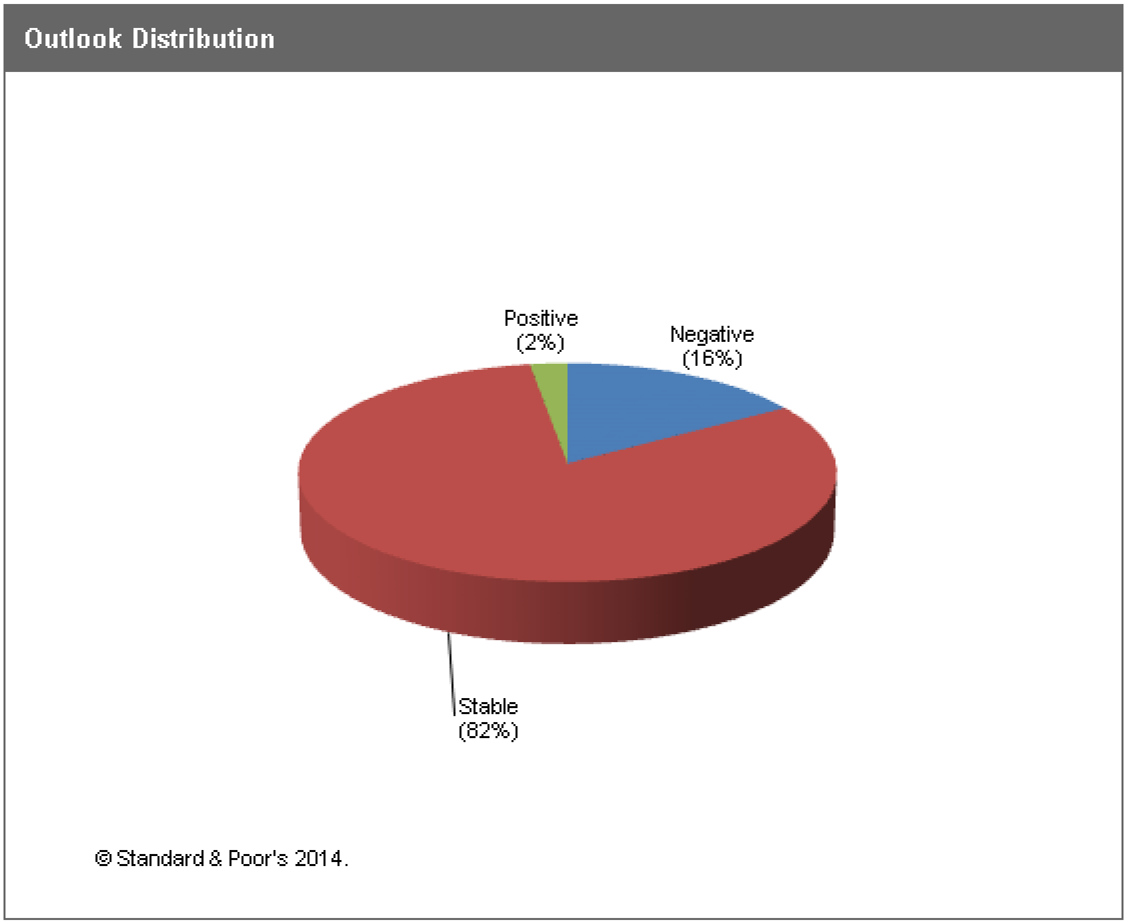


Chart 2



First defaults of rated debt in the sector occurred in 2013

Consistent with the overall negative actions during 2013, we saw the first default of a charter school that Standard & Poor's rates late in the year. Bradford Academy, Mich., was unable to work within what we view as restrictive state legislative environment, in which a school may pay debt service from only 20% of its state aid payments. Together with the Detroit area's population losses, increasing competition, and insufficient alternative funding sources, the charter school was unable to make a scheduled principal payment to bondholders.

We anticipate another default during 2014: North Star Charter School, Idaho ('C') may be unable to service its debt payments and is currently operating under a forbearance agreement. It was unable to expand operations sufficiently to manage debt service requirements after opening a new facility, which highlights the risks of growth and becoming overleveraged. Given these instances and numerous other covenant violations over the past couple of years, we have become increasingly skeptical of management projections and have a lower tolerance for weakening financial performance.

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Sophisticated Management Will Be Key To Stronger Performance

Charter school leaders will need to become increasingly sophisticated and diverse in their knowledge of finance, education policy, and administration in order to navigate the many changes the sector is facing. An ability to remain fiscally sound and improve the school's financial profile while balancing various academic demands and learning objectives for which the school was originally started are needed to steer the course to a sound credit profile.