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Community Investments Vol 16, Issue 1
CI Notebook

Author(s): Lena Robinson, Community Affairs Specialist, Federal Reserve Bank of San Francisco
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Think about the last time you felt ill. Did you have the medical insurance that would allow you to be seen at a hospital or better even, by a specialist? Are you thinking about starting a family and calculating the cost of child care? Do your children receive the quality of care or education you expect? These questions and concerns are not restricted to individuals of limited financial resources. They extend to everyone regardless of means. "Better than decent" schools, clinics, daycare centers and other community-based facilities should be the standard for all neighborhoods and not just available in only middle- and upper-income communities.

This issue of Community Investments shares examples of how financial institutions, nonprofit lenders and other intermediaries are working to achieve this goal. For financial institutions, supporting the development of new and improved community facilities can be CRA-eligible. Whether a charter school, health clinic, child care center or housing development, facilities not only mean construction jobs in the short-term, but they also bring permanent jobs, ancillary support services and increased revenue into the community, which are the linchpins of revitalization.

The organizations highlighted in these articles have developed the specialized expertise required for underwriting, investing in and lending to community facilities. The full online articles will help you to better understand the challenges faced by childcare facilities, public health clinics, charter schools and nonprofit organizations in finding the capital to serve the needs of their constituents, as well as the solutions that have worked.

There is a great deal to be learned from the success stories shared by these authors. But in order for there to be more success stories, you as the reader must ask yourself, “how can I contribute to the realization of these efforts?” Take a moment to jot down your answers, then contact the author to share them. Hopefully, this will be the beginning of new partnerships that create better healthcare, childcare, housing and technical assistance for those who really need it.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 16, Issue 1 W^3 Wall Street Without Walls: Preparing Community Development Organizations for the Capital Markets

Author(s): John Nelson and Greg Stanton, Wall Street Without Walls
May 2004

The objective of Wall Street Without Walls (W^3) is to connect the traditional institutions and financial products of the capital markets with community-based development organizations (CBDOs) engaged in the diverse work of community economic development in low- and moderate-wealth communities both urban and rural. Wall Street Without Walls was created to encourage, organize and facilitate the provision of volunteer investment banking and ultimately capital markets services that improve economic conditions in low-wealth communities and the nonprofits that serve them. The mission of W^3 is to encourage bankers' volunteer involvement and advance the profession's responsibility to serve the needs of the nonprofit, economic and community development industry.

Similar to "Doctors Without Borders," this program is an opportunity for finance professionals to give of their expertise in addressing pressing social concerns by partnering with local economic development organizations that serve emerging small businesses, individuals, and families. This much-needed technical assistance capacity harnesses Wall Street expertise in real estate, structured, public and nonprofit bond finance, with demand for our intervention growing dramatically over the past year.

Who Benefits

Under the initial leadership of former Wall Streeter Greg Stanton, The Wall Street Without Walls Program (W^3) has successfully provided financial technical assistance to medium and large nonprofits seeking advice on how they can more efficiently finance their assets and operations using the capital markets. The program matches community-based organizations with teams of volunteer bankers and finance professionals who provide help on a pro bono basis. Small business loan funds, housing developments, commercial sites, mixed-use projects, and factory/industrial sites are some of the projects that have benefited from the technical assistance of W^3 professionals.

How It Works

Participating nonprofit organizations seeking financial technical assistance submit their specific financing needs or transaction questions for deals over $3m through trade associations serving the field such as the National Congress for Community Economic Development, LISC, the Enterprise Foundation, National Community Capital, and the Neighborhood Reinvestment Corporation. The Securities Industry Association (SIA) works with W3 to manage, track and assist the volunteer process to be productive for both the volunteers and the nonprofits. To get the word out, a series of outreach and training programs were conducted in 2003 in partnership with the Federal Reserve Bank system and underwritten by the Fannie Mae Foundation.

Understanding the Obstacles

Capital to finance various community assets such as single and multifamily affordable housing, small business loans, consumer loans and community facilities is currently provided by a host of mission-driven financial intermediaries, such as community development financial institutions, community development corporations, revolving loan funds, community development credit unions, and micro-lending financial intermediaries. Yet, the increasing demand for capital to support these mission areas, is not able to be met by the current supply of traditional philanthropic, government, and concessionary rate capital, including loans from banks often provided under the aegis of the Community Reinvestment Act. And while there have been a few CBDOs successful in achieving limited access to financing from institutional investors, according to specialists in the field, such as Kevin Smith, executive vice president of the Fannie Mae Foundation, "…there is an inadequate flow of capital into the community development finance system to fulfill the supply needs for affordable housing and build healthy, vibrant communities nationwide."

Some of the problem areas and systemic blockages to the capital markets may be caused by inadequate infrastructure, lack of preparedness, or unwillingness by CBDOs to adopt market standards. These are the problem areas that need to be addressed collectively by the entire field, including government agency partners, trade associations, foundations, and practitioners themselves. The major activities which require collaboration are:

1.) conforming assets,
2.) improving systems,
3.) finding credit enhancement, and
4.) adopting common standards.

Our discussion of the major obstacles such as scale or performance augments other important current research and pilot projects, which are dedicated to finding solutions to the capital shortage for this nation's most depressed communities, minority businesses and aging infrastructure. The premise of W^3's effort is that access to sustained capital markets is a function of increased scale, standardization of practices, documents and processes, and improved skills in managing capital markets.

Identifying Solutions

Improvements or innovations which may be helpful in improving capital markets access for the community development finance industry include providing CBDO managers with advanced financial skills. These skills can enhance an organization's lending practices to ensure profitability and long-term sustainability. The efforts to close the 'capital gap' will be based on the success of CBDOs accessing mainstream markets by achieving scale by partnering with other CBDOs and using the market's customary structures. The collaborative efforts must meet and pass institutional investors' due diligence and appetite for various security types. This includes engineering financial products, using the New Markets Tax Credit (NMTC) to appeal to institutional investors; accurately documenting asset performance; quantifying mission liquidity needs and market size; and designing innovations necessary to isolate perceived and actual risks related to CED investments.

The innovations from W^3 include:

- forming community development financial guarantees and financial wraps custom-tailored for CED products but shaped by generic investment grade institutional investor demand
- using 'dead' and underused government assets, such as the assets of HUD auctions, to provide additional collateral to raise CED transaction credit quality and reduce financial guarantee and transaction costs;
- developing financial products for funding programs that use the New Markets Tax Credit
- modernizing the community-based organizations' approach to financing and asset management – from the Portfolio Method of Financing (PMF) to a Capital Markets Financing (CMF) method of asset management. The CMF method originates, packages and sells assets to increase capital and liquidity, rather than just originating assets and managing them through maturity.

The W^3 program calls for bold action and leadership from CBDO practitioners and finance professionals. The shared goal is to stand on common ground and identify methods to efficiently finance pools of non-conforming assets. Bold action calls for substantively improving systems of tracking and servicing assets, finding more cost-effective means of credit enhancement, and adopting standards which are accepted by capital markets. Bold action requires strong debate and analysis on how communities can access capital. Bold action must address an widening capital gap and move it to a priority position on the national agenda. Financial leadership will be required to make the hard decisions that need to be made, such as closing down failing or inefficient CDFIs. But, financial leadership may also stimulate new ideas for developing practical measures for rewarding excellence and achieving higher levels of social impact.

How we view these obstacles and what we do to overcome them profoundly influences society. With a heightened sense of urgency, we must investigate how to integrate mission needs into viable and investment grade capital markets instruments. There are other ideas and innovations being discussed in the field. W^3 has been developing innovative concepts and recommendations to the CED field. The top four include:

> 1.) establishing a financial guarantee corporation or capability to provide a financial guarantee by credit enhancing or wrapping CED transactions to investment grade credit quality;
>
> 2.) establishing a CED financial product task force for HNW and Institutional Investors;
>
> 3.) developing peer-to-peer lending capacity for CBDOs in the form of a capital exchange system;

4.) and establishing an intensive Capital Markets training program alongside the Federal Reserve Bank's community affairs programs.

All of these efforts are in place thanks to the ongoing support of the Fannie Mae, F.B. Herron, and Kellogg Foundations and the cooperative efforts of the Federal Reserve Banks. W^3 has conducted its one-day Orientation to the Capital Markets program for CBDO practitioners with the Federal Reserve Banks in Boston, Richmond, Atlanta, San Francisco, and New York with others scheduled in 2004. W^3 has also held a follow-up more intensive three-day Capital Markets Training Institute at Southern New Hampshire University's School of Community Economic Development. These sessions were supported by industry partners including Impact Community Capital, Fleet Community Investment Group, and BB&T.

W^3 seeks other partners and sponsors to support further distribution of these innovations in different regions of the country to nonprofit community-based development organizations like CDCs and CDFIs. We also seek financial companies and individuals wishing to participate as pro bono financial technical assistance providers. For further information contact our web site: www.WallStreetWithoutWalls.com.

John Nelson and **Greg Stanton** are program co-directors. They can be reached in their offices respectively in Washington DC: 703-648-9544 / John Nelson or New York: 212-977-2759 / Greg Stanton.

Community Investments Vol 16, Issue 1 Supporting Community Health Centers

May 2004

Although they serve a predominantly low-income population, community health center facilities do not have to look like it. This California facility pictured above, completed in 2000, is one of seven service delivery sites managed by a community health center with a $14 million annual operating budget. The health center is co-located with low-income senior housing as part of a campus that allows seniors to remain in their community. This state-of-the-art facility also includes an adult day health center that accommodates approximately 20,000 patient visits annually. Virtually all of the health center's patients live at or below 100 percent of the federal poverty level, which is less than $9,000 in annual income for an individual or about $18,000 for a family of four.

The campus occupies space in a predominantly residential neighborhood with a handful of small service businesses in the immediate area. It replaced decaying housing, which provided a notable improvement to the neighborhood. For every job created by the health center, it is estimated that another 1.5 jobs are created in the community to provide support services to the facility and its users.

Like many health centers, this facility was constructed with a combination of fundraising and debt. A strong capital campaign allowed the health center to raise more than 30 percent of the construction budget, which is above average for many capital campaigns. The balance of the project was financed with a combination of conventional loans and tax-exempt debt.
In Supporting Community Health Centers: Strengthening the Health Care Safety Net through Financing and Technical Assistance Scott Sporte of the NCB Development Corporation (www.ncbdc.org) and Mark Lurtz of Capital Link (www.caplink.org) discuss their organization’s efforts to increase the availability of health clinics throughout this country.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 16, Issue 1 Strengthening the Health Care Safety Net through Financing and Technical Assistance

Author(s): Mark Lurtz, Capital Link & Scott Sporte, NCB Development Corporation
May 2004

Introduction
Nonprofit community health centers meet the primary care needs of many of the nation's Medicaid recipients and uninsured in areas traditionally underserved by physicians, regardless of the patients' ability to pay. These organizations act as the nation's health care safety net, offering a full spectrum of care that is sensitive to each community's unique needs from over 3,500 delivery sites in underserved urban and rural areas nationwide. Community health centers rely on a combination of federal and state grants, Medicaid and Medicare reimbursement, patient fees, private insurance payments, and donations to provide care, underscoring the need for cost-effective delivery.

In this time of economic uncertainty, community health centers face many challenges in providing high-quality primary care to low-income patients.

Uninsured populations increase with growth in unemployment, placing pressure on providers and facilities. State budget deficits force reductions in entitlement programs. Organizations find it difficult to recruit and retain staff willing to work for lower wages in older facilities. In addition to rising costs, shifting reimbursement streams, and the strain of a constantly growing demand for their services, health centers have traditionally encountered difficulty in obtaining appropriately structured financing for working capital, building projects and equipment needs. This is often due to a perception that their clientele, their funding and their location make them a higher-than-average risk.

Financial Strength

Fortunately, experience has shown that community health centers and other community-based health care providers are remarkably resilient and resourceful. A recent survey of health centers in California administered by Capital Link, a nonprofit technical assistance provider to community health centers nationwide working in conjunction with the Tides Foundation and the California Primary Care Association, has found that community health centers in California have been and are increasingly becoming more financially stable.[1] The survey, conducted with information collected from health centers throughout California for fiscal years 1999-2002, uses several financial measures to determine an organization's financial condition, including liquidity, debt capacity and profitability (see box 1).

Box 1

Measure	1999	2002	Percent Change
Number of respondents	47	79	68%
Days cash on hand (median)	33	66	100%
Days in Receivables (median)	60	55	(8%)
Operating margin	1.85%	4.42%	139%
Debt service coverage	2.43:1	2.78:1	14%

Although this survey covers a subset of community health centers in California, it is not inconsistent with results seen in other states. The survey results overall demonstrate a group of organizations that are in line with traditional financial benchmarks and substantiate that many health centers nationwide present an acceptable credit risk.

Lending to Health Centers
by Scott Sporte

One national lender agrees that community health centers are a good credit risk and has made them the core of their lending activity. For nearly 20 years, NCB Development Corporation (NCBDC) has worked with community-based health care providers to fill the gap of financial knowledge and need, provide assistance and offer a variety of appropriately structured loan products to finance working capital needs, facility acquisition, expansion and renovation, and new equipment. NCBDC's mission is to deliver innovative financial and development services that improve the lives of low-income individuals, families, and communities.

Health centers suffer from the perception that they are a health care provider of last resort, with outdated facilities to match. But with financing from NCBDC, health centers in many parts of the country have been able to improve their facilities' efficiency and capacity while maintaining a high quality of care for their patients. Using their own balance sheet, and working together with their affiliate, the National Cooperative Bank, and other investors, NCBDC has committed more than $200 million in financing to health care providers in underserved communities nationwide, with losses totaling less than 0.1%.

One recent example of project commonly financed by NCBDC is a community health center that desired to construct a new facility and move from cramped rented space. This health center's board and management wanted to construct a building that would be a focal point for their community but wouldn't, in their own words, "look like a clinic for poor people." Business planning assistance from Capital Link helped management develop a set of growth projections and evaluate different financing options. For this project, a $4 million construction and permanent loan from NCBDC complemented the clinic's $500,000 capital campaign to make the new building a reality. Payments were structured to anticipate improved cash flow after an initial ramp-up period, and NCBDC worked closely with management to structure payments that matched expectations.

Developing Innovative Financing Pools

For many years NCBDC's own balance sheet was adequate to provide the bulk of their financing. And although they were able to provide loans under terms not generally available to most health centers, their capital could only take them so far and would only allow them to work with a comparatively small number of health centers. Their desire to increase access to capital for health centers necessitated a focus on developing new products and services, which led to the creation of the HealthCAP loan program, a public-private partnership that leverages their limited resources.

HealthCAP is a $14 million loan pool developed in partnership with the California Health Facilities Financing Authority and the Metropolitan Life Insurance Company. Through the program, NCBDC makes loans to health facilities, selling a portion of each loan to Metropolitan Life. NCBDC retains a small percentage of each loan as subordinate debt, strengthening the investor's senior participation and, through a reduction in exposure and leverage, helping the investor to reduce return requirements. At the same time, NCBDC's participation allows them to remain connected to each transaction while freeing their balance sheet to make additional loans. Credit enhancement from the state's financing authority provides added security.

The HealthCAP program has proven to be quite popular, and NCBDC believes that this is just the beginning.

NCBDC is eager to build on their successes in the health care market, and are working to expand HealthCAP in California and develop new programs in low-income communities all over the country. They are continually seeking partnerships with interested investors and lenders. Through an innovative structure designed to minimize their risk, the financing pools NCBDC has created help to meet the unique financing needs of health centers and other community-based organizations while at the same time allowing NCBDC to leverage their balance sheet and offer a greater number of loans under favorable terms. The investors and lender partners who join in the capital pools gain an introduction to community health center financing. The health centers benefit from modern facilities, and underserved communities benefit from improved access to health care.

Technical Assistance and Consulting Services
by Mark Lurtz

Capital Link is a national nonprofit consulting organization that works with health centers to prepare preliminary project feasibility analyses, business plans and financial forecasting, space plan analyses, request for proposals, and other planning assistance designed specifically for community health center capital projects.

Capital Link contracts with the Bureau of Primary Health Care, a department of the federal Health Resources and Services Administration under the auspices of the Department of Health and Human Services, to provide these services nationally. In addition to its contract with the Bureau of Primary Health Care, Capital Link has agreements with the Tides Foundation in California to provide services to health centers in California. As a result of these grants and contracts, Capital Link provides many of its services without charge to community health centers, making capital projects even more affordable to centers seeking to expand their capacity.

Since 1995, Capital Link has assisted 73 health centers throughout the country in securing over $160 million in debt financing and grant funding for projects totaling more than $212 million. As health centers expand, so does the need for financing options. Fortunately, with organizations like NCB Development Corporation as a model, the job of educating lenders about community health centers and the unique financial opportunities and challenges they face has become less difficult.

Lenders, government agencies, economic development resources and foundations are finding community health centers are more than health care providers, they are economic engines. Capital Link works with community health centers to quantify the impact that they have on the local community with an economic modeling tool that uses multipliers to show the direct and indirect effect of an organization providing jobs and income to employees and other businesses, which then ripples through the local economy. In some places, a community health clinic can serve as the catalyst for revitalization.

So important is the need for community health clinics, that President Bush increased federal operating support to enable community health centers to double their capacity by opening 1,200 new or expanded service sites between 2002 and 2006. In a recent speech,[2] President George W. Bush addressed this need and reaffirmed his continuing support of the growth and expansion of community health centers with additional congressional dollars. And while this federal expansion initiative, entitled the Health Center Growth Initiative,[3] provides increased operating support, the challenge remains to identify financing for community health center capital projects, including greater lender support.

Although community health centers face many concerns in providing care to low-income individuals, the challenge of facilities development is not insurmountable. Community health centers are essential community resources with a real necessity for capital expansion financing dollars to meet a growing health care need.

It is essential that lenders view community health centers as vital resources and seriously consider them as viable borrowers. As outlined by Scott Sporte of NCB Development Corporation in this article, there are ways to minimize a lender's risk including pooling of resources.

The results of participating in Community Health Center capital projects include lenders having an opportunity to supply viable businesses with much needed capital, health centers benefiting from modern facilities and underserved communities receiving improved access to health care.

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[1]Survey information was provided by Capital Link from its report entitled, California Health Centers and Clinics Financial Trends FY1999 – FY 2002, January 14, 2004. This report was prepared with support from the Community Clinics Initiative, a joint program of Tides and the California Endowment.
[2]http://www.georgewbush.com/HealthCare/ Read.aspx?ID=2331 (Beginning with Paragraph 20)
[3]http://www.ncsl.org/programs/health/hrsaslides1/sld001.htm

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Scott Sporte *is director of business development in NCB Development Corporation's Oakland, California, office. NCBDC is a national nonprofit organization that acts as a catalyst seeking to change the systems for delivering affordable housing and essential community services to the nation's underserved communities. The organization's primary focus is on the things that matter most to people living in low-income communities: housing, health care, education, worker ownership and economic and* *community development. NCBDC has consistently offered the financial services and technical assistance needed to improve health care quality in underserved communities, working with providers of a variety of health care and mental health services covering a full spectrum from prenatal care to services for the aging. In addition to their work with community health centers, NCBDC has worked with substance abuse rehabilitation agencies, job training and support organizations for people with physical disabilities, PACE providers and adult day health organizations, and community hospitals that provide a majority of their care to low-income populations. For more information, visit www.ncbdc.org.*

***Mark Lurtz** is marketing manager for Capital Link's eight offices located in Boston, MA; Bethesda, MD; Atlanta, GA; Austin, TX; Cary, NC; Jacksonville, IL; Sacramento, CA and Seattle, WA. Capital Link is a national nonprofit consulting organization that provides high-quality, affordable, innovative advisory services related to planning and financing capital projects for nonprofit community health centers to support and expand community-based health care. For more information, visit Capital Link's website at www.caplink.org.*

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Community Investments Vol 16, Issue 1
Financing Facilities for Children

May 2004

ABCD Initiative
by Noni Ramos, Low Income Investment Fund

The overarching goal of the Affordable Buildings for Child Development (ABCD) Initiative is to build a comprehensive and sustainable financing system for high-quality child care facility development with the objective of creating 15,000 spaces in five years with a particular focus on low-income communities. However, experience has shown that it takes more than just funding to meet the demand for affordable and high-quality childcare facilities. That is why the ABCD initiative utilizes the expertise and capacity of existing community organizations, while employing four interrelated strategies.

ABCD Fund – Provides technical assistance, grants and loans for child care centers, feasibility planning, acquisition, and construction costs, and long-term real estate financing needs.

ABCD Development Assistance – Utilizes the expertise of regional community developers to increase statewide the construction of child care facilities within educational, health, and housing facilities. Partners include

Bridge Housing, Los Angeles Community Design Center (LACDC), Mercy Housing California and Child Development, Inc. (CDI).

ABCD Constructing Connections – Strengthens the facilities development expertise of child care center operators and intermediaries, and improves the regulatory and funding environment to support child care facilities as a priority.

ABCD Campaign to Sustain Child Care – Brings together new coalitions of representatives of a variety of sectors to advocate for increased child care program operating subsidies from state and local governments.

Read The Next Stage in Childcare Facilities Development to learn more about this four-pronged strategy.

Charter Schools
by Susan Harper, Low Income Investment Fund
Financing of charter schools is a way for banks to assist the public school system. Many charter schools open in low- and moderate-income communities and are created on derelict or long neglected property making them a catalyst for revitalization and stabilization, an activity that is supported by CRA.

In *Funding Our Future: Charter School Finance 101*, Susan Harper, the program manager of the California Charter School Program at the Low Income Investment Fund www.liifund.org (LIIF) writes about the financing needs of charter school, including a discussion of traditional financing for school facilities, and the critical need for cash flow financing of budget shortages that occur due to mid-year school funding disbursements by school districts.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 16, Issue 1 The Next Stage in Childcare Facilities Development

Author(s): Noni Ramos, Director of Child Development and Education, Low Income Investment Fund and Chief Credit Officer of Community Facilities, ABCD Fund
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> One of the charges of the district Fed banks is to provide analysis and insight into regional economic development. State and local governments have been debating how to best use public funds to encourage economic growth, and research has shown that early childhood development programs should be viewed as economic development.

- Minneapolis Fed Vice President James Lyon at The Economics of Early Childhood Development: Lessons for Economic Policy conference, October 20, 2003 hosted by the Minneapolis Fed and Minnesota's McKnight Foundation in cooperation with the University of Minnesota[1]

What's At Stake?

The socioeconomic impact of inadequate child care, in terms of lost potential to promote healthy growth and development, cannot be underestimated. According to the Chicago Longtitudinal Study (2000),[2] quantitative savings in terms of crime, welfare dependency, and special education will result in a return of more than $7 for every $1 invested in quality early-intervention child care. The study calculated a potential savings of $2.6 billion for every 100,000 children participating in the programs.

Limited Supply

Lack of facilities is probably the greatest challenge facing early childhood programs. In California, the supply of licensed child care, estimated at nearly 900,000 spaces in more than 40,000 child care businesses, meets only 22 percent of spaces needed.[3] The child care needs of the estimated 2.3 million California children in poverty are particularly acute with more than 200,000 low-income children on waiting lists for subsidized child care. The alarming shortage of affordable, high-quality child care is a significant barrier to families aiming for economic self-sufficiency. Child care is frequently financially out of reach for low-income families, and there simply are not enough child care spaces to meet the demand for children of any income. The problem is not prevalent just in California, but nationwide.

The need for a stable and efficient source of capital to finance the development of child care facilities across the nation is critical. Without sufficient funding for high-quality facilities, low-income families are forced either to refrain from working in order to care for their children, or place their children in unlicensed and perhaps unsafe child care environments. Ultimately, the critical need and value of child care spaces, particularly for low-income families, is clear, as is the necessity for a well-developed financing system to support the continued development of high-quality child care facilities throughout the nation. Seeking to address this shortage, the David and Lucile Packard Foundation, and its partners, launched the Affordable Buildings for Children's Development (ABCD) initiative in 2002.

Addressing the Need

The overarching goal of the ABCD initiative is to build a comprehensive and sustainable financing system for high-quality child care facility development with the objective of creating 15,000 spaces in five years with a particular focus on low-income communities. The initiative adopts a four-pronged approach of finance, technical assistance, construction advice and advocacy to achieve this goal. The Low Income Investment Fund (LIIF), a community development financial institution, was chosen to assume leadership of the initiative in 2003 (see box 1).

The ABCD initiative adapts a proven model drawn from the affordable housing financing system of using private capital to leverage public funds. Even in good economic times, it is doubtful that the public sector could sufficiently supply the capital investment to support construction of the number of child care facilities required. As such, ways must be found to attract and sustain new sources of private investments, including loans. The ABCD initiative operates from the hypothesis that increased involvement of private capital will expand public dollars and increase the commitment of lenders and investors who have historically been involved in other areas of community development such as housing and small business. As the financial industry increases their commitment, their overall support and interest in children and child care will become not simply philanthropy but "good business." In other words, just as private investors have joined government funders for today's affordable housing initiatives, the private sector will come to value the investment potential in child care facilities development through ABCD.

Since its inception in January 2003, ABCD has made solid progress, including:

- committing approximately $4 million in grants and loans that will support development of nearly 1,800 child care spaces;
- raising $10 million from a consortium of insurance companies for the ABCD Fund, through the New Markets Tax Credit program; and

- receiving a $3 million grant over three years from the First 5 California Commission for ABCD Constructing Connections (see box 2).

Getting Involved
In order for the ABCD Initiative to be successful, LIIF will require the participation of financial institutions in the following ways:

1. lending the ABCD Fund, low cost, flexible capital to be used to make child care center loans;
2. providing grants to LIIF for re-granting to child care centers for planning facility projects; and
3. providing grants to LIIF for the operations of the ABCD Fund.

The ABCD Fund is currently capitalized at $10 million with an additional $10 million currently being closed with a consortium of insurance companies. LIIF's goal is to grow the Fund to between $30 and $40 million in capital available for lending.

Because traditional financial institutions do not typically have experience in making loans for the development of child care centers, LIIF can play a critical role in serving as the intermediary between the financial institutions that have the capital to lend and the borrowers developing child care centers. In most instances, the borrowers are first time borrowers, unfamiliar with the loan underwriting process. Over the years, LIIF has developed an expertise in lending for the purpose of child care center facilities development and by lending to LIIF --an established CDFI with a strong track record-- rather than to individual child care center, financial institutions can take advantage of this experience and expertise.

Additionally, such characteristics as often being unsecured, having high loan-to-value ratios when secured by real estate, lower than typical debt service coverage ratios, and cash flow that is dependent on annual appropriations of child care subsidies tend to make them weaker than usual borrowers from a financial perspective. By lending to LIIF, many of these risks can be mitigated because of LIIF’s expertise in lending to this field.

The ABCD Initiative as a Model for Other States

The ABCD initiative is most concerned with putting into place key elements that will ensure a sustainable system for child care facility financing and serve as the underpinning of affordable child care facilities development for years to come. These elements include:

- enlisting new and diverse partners such as employers, health care providers, and housing owners to provide support such as sites or other resources;
- working to ensure that investors see childcare center financing as an attractive community development opportunity;
- mobilizing substantial new public and private dollars for facility development and organizational support of the child care sector; and,
- increasing financing options for childcare providers.

The four components of the ABCD Initiative summarized in Box 2 are an attempt to address the elements that are believed to be critical to the system building that we have identified as being necessary for accomplishing the overall goals of the ABCD Initiative.

Box 1

Who is LIIF?

Since its inception in 1984, LIIF has provided capital and technical assistance totaling over $353 million in 35 states across the nation to hundreds of community organizations serving the nation's hardest-to-reach populations. LIIF's assistance, in turn, has leveraged investments in poor communities of more than $3.2 billion.

LIIF, which operates nationally, has developed expertise in lending to borrowers with unconventional revenue streams and provides financing for all phases of a development project (including permanent mortgages), as well as operating lines of credit for nonprofit organizations. A prominent board of directors, drawn nationally from the banking industry and the national housing development and policy fields, governs LIIF.

To learn more about LIIF's role in facilitating community development finance and investments, visit their website at www.liif.org

Box 2

The Four Components of the ABCD Initiative

Experience has shown that it takes more than just funding to accomplish these goals. That is why the ABCD Initiative utilizes the expertise and capacity of existing community organizations while employing four interrelated strategies:

ABCD Fund – Provides technical assistance, grants and loans for child care centers, feasibility planning, acquisition, and construction costs, and long-term real estate financing needs.

ABCD Development Assistance – Utilizes the expertise of regional community developers to increase statewide the construction of child care facilities within educational, health, and housing facilities. Partners include Bridge Housing, Los Angeles Community Design Center (LACDC), Mercy Housing California and Child Development, Inc. (CDI).

ABCD Constructing Connections – Strengthens the facilities development expertise of child care center operators and intermediaries, and improves the regulatory and funding environment to support child care facilities as a priority.

ABCD Campaign to Sustain Child Care – Brings together new coalitions of representatives of a variety of sectors to advocate for increased child care program operating subsidies from state and local governments.

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[1]Link to proceedings from the The Economics of Early Childhood Development: Lessons for Economic Policy conference. (http://www.mcknight.org/cfc/news_detail.aspx?itemID=355&catID=55&typeID=2)
[2]The Chicago Longitudinal Study (CLS), a report completed by the University of Wisconsin and published in August of 2000, investigates the educational and social development of 1,539 low-income children who grew up in high-poverty areas in Chicago. (http://www.waisman.wisc.edu/cls/index.html)
[3]Child Care Portfolio, 2001; a bi-annual report analyzing the supply and demand for child care by county in the state of California created by the California Child Care Resource and Referral Network. (http://www.rrnetwork.org/rrnet/index.htm)

For more information, you may contact **Noni Ramos** at the ABCD Fund, 510-893-3811, ext. 319, or via email.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol 16, Issue 1 Funding our Future: Charter School Finance 101

Author(s): Susan Harper, Community Facilities Senior Loan Officer, Low Income Investment Fund and Program Manager, California Charter School Program

May 2004

Introduction

A charter school is an independent public school established and operated under a charter for a fixed period of time.[1] Charter schools have the flexibility to operate free of many of the rules and regulations that govern traditional public schools' educational program, facilities and operations in exchange for increased accountability and scrutiny. They must be non-sectarian and must admit on a first-come, first-served basis or select from a lottery if demand exceeds capacity.

Minnesota was the first state to pass charter legislation in 1991; California followed in 1992. There are now 3,000 charter schools operating nationwide, serving approximately 690,000 students in 40 states plus Washington, D.C. and Puerto Rico (see box 1).[2]

Unlike district public schools, charter schools do not have direct taxing or bonding authority—two vehicles for financing traditional public school capital expenditures. While a handful of states have begun to create new programs to help charter schools finance capital and other start-up expenditures, most states still require charter schools to finance their start-up and facilities expenditures out of general operating revenues, privately raised funds, or partnerships with other organizations.

LIIF's Involvement

Without sufficient public funding for quality facilities, charter schools face considerable uncertainty and instability as they often begin in temporary space not intended for educational purposes and must deal with the disruption of moves to new locations. One such example is a project in Inglewood that is converting a hospital to a school (see box 2). With the growth in the charter school field including 155 new charter schools in California since 2000 there is clearly a significant need for widely available, reliable capital to finance charter school facilities.

Because of its ability to aggregate capital, provide technical assistance, and creatively finance community facility projects, the Low Income Investment Fund (LIIF) is well equipped to add value to the charter school field to help solve the facilities challenge. As a national community development financial institution (CDFI), LIIF is a steward for capital invested in housing, child care, education, and other community-building initiatives including workforce development. LIIF currently has access to over $200 million in capital for community development projects: $100 million in on-balance sheet assets and the remaining $100 million in off-balance sheet capital for which LIIF is the sole administrator.

In 1999, LIIF formally incorporated education into its strategic plan, believing that education is a key component in economic mobility and asset growth for low-income households. Additionally, a number of LIIF's nonprofit community development borrowers want to serve a broad range of needs in their communities, recognize that the demand for quality alternatives to public education in certain neighborhoods is high, and seek community-based responses to those needs.

All of LIIF’s charter school lending to date has supported schools that serve low-income and disadvantaged populations and/or poor communities. This charter school lending activity, inclusive of participation amounts from LIIF’s lending partners, has consisted of nine loans approved to eight schools totaling $12.6 million. LIIF’s loans have ranged in size from $100,000 to $6.3 million, providing schools with a range of facility acquisition, construction, and renovation financing and supporting 1,957 quality charter school spaces.

LIIF’s demonstrated expertise in capital market financing, knowledge of the charter school market, and successful underwriting of loans to community-based organizations resulted in LIIF’s being awarded a grant of $3 million in the first round of the U.S. Department of Education (DoE) Charter School’s Facilities Financing Demonstration Program. This grant, one of five competitive grants made nationwide at the time, was made to help LIIF implement a lending program for charters schools in California. LIIF is using this grant as loan loss reserve funds to leverage $64 million in private capital that LIIF and its partners are actively raising for further financing of charter school facilities. With a pipeline of over $30 million in projects that will require financing in the next two years alone, LIIF is currently looking to tap new capital sources.

Underwriting Charter Schools

LIIF has had no losses on its charter school portfolio, despite the perceived risks of lending to charter schools, which include a limited charter life, uncertainty over public funding, and newness of the market. LIIF has provided financing to both start-up and existing schools, schools that receive assistance from management companies, and those managed independently. As a result of the variety of these transactions, LIIF has first-hand knowledge of the complexity of underwriting charter school loans.

Below LIIF presents a summary guide to underwriting charter schools. While there are many other factors to consider than those presented, this discussion focuses on aspects of charter schools with which commercial real estate lenders may be unfamiliar.

Financial Analysis

LIIF reviews the systems, policies, and procedures that a school has developed to monitor, analyze, and manage its finances. It is important to ensure the quality of financial reports and financial management because of charter schools' reliance on public funding and accountability. Beginning with the '04-05 school year, recently passed California legislation requires charter schools to produce quarterly financial statements and annual audits.

The majority of charter school revenue is calculated based on average daily attendance (ADA) – not on enrollment. For example, if a school has enrolled 100 students, but only 90 percent ADA, the school will receive funding for 90 students. The vast majority of school revenue comes from public sources. All California charter schools automatically receive General Purpose Block Grant, Categorical Block Grant, and Lottery funding. Other programs are only available if the school enrolls low-income students (e.g., federal Title I funding) or applies specifically for that funding (e.g., staff development money). It is important to understand the timing, reliability, and conditions associated with each revenue source.

Because of the relatively low per-pupil funding for California charter schools, (as compared to public schools, which have access to capital funding, and other states' overall spending) many schools depend on some level of fundraising. Obviously, if a school is reliant on fundraising, it is important that they demonstrate a strong fundraising track record and pipeline. Schools may also need to attain certain milestones to draw down the funding and adhere to a set schedule by which the funding is released. Fortunately, California charter schools are also eligible to apply to the California

Department of Education (CDE) for a grant of up to $450,000 for planning and implementation costs, which is released over a three-year period. Finally, LIIF asks such schools to prepare a budget showing viability with only committed funds.

Personnel expenses are the single-largest category of expenses for charter schools, often representing 50 to 70 percent of the budget. And although charter schools have more flexibility over public schools since the union and wage scales that affect public schools do not usually apply, personnel budgets must be sufficient to attract talented teachers and administrators and to meet target teacher-student ratios. Other significant expenses include curriculum materials, books, computers, equipment, and supplies, which typically range from five to fifteen percent of a school's budget. In addition, charter schools often contract with outside companies to manage their financial and operational needs. These fees can range from five to twenty percent of the budget.

Facility costs will vary based on factors such as the nature of ownership or lease and the age, location and size of the facility. An ideal school facility provides 75-100 square feet per student; of this amount, about 50 percent should be allocated for classroom space. (However, many schools, whether by choice or limited budgets, make do with less space.) Occupancy costs should not exceed 20 percent of revenue; a 2001 study of charter schools nationwide indicated an average of 12 percent.[3]

Finally, California state law requires districts to charge a one percent administrative fee for services provided to charter schools, and, if the district provides a facility for the school, they can charge up to three percent. It is important to ask whether and what level of operating reserve the school's charter requires. In addition, LIIF will typically also require a replacement reserve, in the range of $0.50-$1.50 per square foot.

Repayment Risk

Understanding the school's track record in attracting, retaining, and increasing its enrollment is critical in terms of assessing a school's ability to repay a loan. Many funders consider 300 to be a minimum enrollment for a school that is seeking to take on financing, although the type and need of the facility and financing will influence that level and LIIF has successfully financed schools with less than 150 students. LIIF monitors a school's waiting list and student attrition rate to ensure that the school remains on target to receive its budgeted revenue. (Approximately two-thirds of charter schools nationwide have waiting lists.)

Needless to say, charter schools can benefit from economies of scale with larger enrollments. However, many charter schools open by offering one grade of instruction and gradually increasing enrollment by adding one grade a year until they reach capacity. While this growth pattern has educational advantages and enables the school to build operational capacity slowly, it presents a challenge in structuring a long-term facility loan so that it can be repaid while the school is still increasing enrollment. (For this reason, many operators will lease temporary space for one-to-three years while they build up the financial resources and capacity to make larger facilities and financing more feasible.) When a school budgets for enrollment growth, not only will teacher costs increase, but the school will also have to allow for additional equipment, books, and supplies for the new children. After the school reaches capacity, costs in these areas, on an annual basis, should actually decline, with on-going replacement costs less than start-up costs.

LIIF also reviews the marketing plan for attracting new students and families. For example, where will the school advertise, how often, and what are possible feeder schools? It is also important to determine the break even enrollment and ADA, below which a school could no longer service its debt, and how likely it is that projections will fall to those levels.

In addition to strong demand and enrollment, accumulated reserves will also mitigate the repayment risk. However, only schools in their third year or beyond are likely to have much of a cushion built up (unless they have been unusually successful in raising private contributions). In the past, California has enacted legislation whereby schools in low-income communities are reimbursed at $750 per ADA up to 75 percent of annual facility lease costs, which has enabled several schools to build up cash reserves. (This funding has been proposed for FY05, although its long-term prospects are uncertain.)

School Management

Because of the importance of strong management to oversee the complicated finances of charter schools and to attract and maintain the enrollment that drives loan repayment, LIIF places a strong emphasis on this area. LIIF analyzes the depth and breadth of management's experience, the recruitment plan for bringing on new staff, and the school's hiring and evaluation criteria. It is particularly important to get a sense of management's track record in operating programs of a similar size. While the experience of the founder is important, it is also critical to ensure that the school has an established management structure in place, with clearly identified roles and responsibilities and, ideally, a clear succession plan.

California requires that teachers of all "core classes" be certified. Schools then hire "classified" staff to teach non-core classes. Some amount of turnover is to be expected, particularly during a school's first few years. What is important is to ascertain the reasons behind the turnover (e.g., poor recruiting, lack of professional development, weak administration). Another discussion to have with the school surrounds the lessons learned from any turnover and the adjustments made to bring about a more stable environment.

In many cases, strong educators come together to form a school, and then seek to supplement their backgrounds by contracting with a variety of third-party management assistance providers for on-going school management. Services provided range from specific technical assistance with finance, curriculum, or real estate development to a comprehensive approach whereby a school's founding body contracts out the entire management and operations of the school to a third party.

There is a range of governance structures in charter schools. In California, some charter schools, referred to legally as "dependent" charter schools, are established or remain a legal arm of the school district or county office of education that granted their charter. Other charter schools, known legally as "independent" charter schools, function as independent legal entities and are usually governed by or as public benefit ("not-for-profit") corporations. Still other charter schools form some sort of legal hybrid or "in-between" structure, in which some governance powers remain with the district or county and others rest with the school governing body. The school's governance structure will be clearly described in the charter.

Another important aspect of a school's governance that LIIF reviews is the board of directors. Not only does LIIF look to see that a school has recruited members with a wealth and diversity of educational and professional experience (e.g., legal, finance, real estate, business or nonprofit management) but also members that represent the community. The relationship between the board, management and the community are also important considerations. For example, does the board have open meetings and are parents and the community involved in shaping the design of the school?

School Charter and Design

Since the charter is what allows the school to operate, it is important to carefully review the charter petition and approval documents from the school’s authorizer. A charter school petition includes a description of the school’s educational program, student policies and recruitment, human resources, governance and management structure, financial projections, and clarification of the roles and responsibilities of key parties. A school’s charter in California is approved for five years (three years if initially approved by the State Board of Education, as noted below). The charter-granting agency has the responsibility to ensure that its charter schools are meeting the charter terms, are fiscally managed well, and are in compliance with all applicable laws. Charters in California can only be revoked or not reinstated for reasons of material non-performance.

Clearly, quality is an important factor, yet it is often hard to assess. LIIF analyzes a school as a business—how will management attract and retain its customers (children and families), what is its competitive advantage, (i.e., what distinguishes it from other schools) and what is its mission? One place to go for some data on academic performance is to review the school’s Academic Performance Index (API) score. California schools receive an API score annually. Recent legislation mandates that for a charter to be renewed, the school must pass one of four tests; one of which is achieving an API score of “4.”

Since the school will be measured against its student achievement goals, it is important to assess how achievable the goals are: can the school’s curriculum and program not only meet the needs of the surrounding community but also help improve student performance; has the curriculum been used before; and what additional resources will be required, given the needs of the students or the special features of the school?

Political

Charter schools remain controversial politically. Many districts are reluctant to approve new charters, in part due to the monitoring required of them as authorizers. Thus, the relationship between the school and its district/authorizer must be carefully considered. In California, the vast majority of schools must first approach the district in which they will be located for a charter. If denied on that level, the school can apply to their county's Board of Education. If further denied, the school then has the option of applying to the state Board of Education. There is proposed legislation right now that would allow public colleges and universities to charter schools; however, the prospects of such legislation are uncertain.

LIIF also researches the district's prior and current relationship with charter schools – how many have they approved, rejected, or revoked? What level of monitoring does the district perform? What conditions must the school meet before it can open? LIIF also assesses the degree of community support for the school and involvement of community partners.

Collateral and Construction Completion Risk
In analyzing charter school loan requests, the emphasis noted above on cash flow, management, and the school's program becomes all the more significant given the difficulty of valuing charter school real estate collateral. The special purpose nature of school facilities, the lack of comparable facilities, and the urban locations which are often undervalued of many schools complicate traditional loan to value analyses.

Schools that do not use state bond money for the acquisition or renovation of their facility or are not locating on school district property do not have to follow traditional public school construction procedures. Of course they must still follow local permitting requirements and code compliance. In LIIF's experience, charter schools often underestimate the time, costs, and skills required to undertake a facility development project. As such, LIIF strongly urges schools to contract with qualified project management personnel and with architects and general contractors that have experience with school projects. It is important to ensure that a school plans and budgets for a back-up facility, in case the renovation of its future home takes longer than expected, potentially delaying school opening in the fall.

Important characteristics of charter school locations include proximity to the students, access to transportation, safety, and age and size of facility. Lenders must be aware that the ability of charter schools to offer a sizable equity contribution or additional collateral varies widely, resulting in the need to creatively structure charter school financings.

Conclusion

LIIF has long recognized the need for all CDFIs to broaden their sources of financing and is a leader in creatively identifying and structuring non-traditional sources of financing for all types of community development facilities, including charter schools. LIIF has had no capital losses on its charter school portfolio, and its 19-year loss rate on all lending is 0.16 percent.

LIIF is actively seeking to raise new capital for a charter school fund and is anxious to bring in financing partners that may be new to this field, whether through contributing capital to a charter school fund or working with LIIF on individual deals. This article was written to provide such partners with a background on underwriting charter school and bridge the information gap, so as to encourage them to participate with us. The need for facilities financing among charter schools is significant, will continue to increase in the coming years, and will require all of us to work creatively to solve the facilities challenge.

Box 1

California leads the nation in number of charter school students. Almost one quarter of the 684,000 charter school students in the United States are located in California. Approximately 2.5% of California’s 6,142,000 K-12 students attend charter schools.

Since the law authorizing charter schools was enacted in 1993, California has authorized 471 charters schools and enrolled 170,000 K-12 students. The 471 charter schools operating in California in 2003 represented a 13 percent increase over the prior year. Since 2000, 155 charter schools have opened in the state.

Recent estimates by the Center for Education Reform (www.edreform.com) have tallied nearly 154,000 students enrolled in California charter schools. The states with the next highest levels of enrollment are Arizona (73,542), Texas (60,562), Michigan (62,236), and Florida (53,350).

Of California’s charter schools, most (70 percent) are startups, or entirely new schools created by community members. The rest are conversions, or traditional public schools that have successfully petitioned for charter status.

About 65 percent of the charter schools are site based, meaning that instruction takes place primarily on a school campus. Another 13 percent are independent study programs. The rest (22 percent) have a hybrid setup, a combination of students attending school on a regular campus with a substantial independent study component in the program. In the history of California’s charter movement, there have been about 20 charter revocations and 30 closures.

Box 2

On May 26, 2004, LIIF approved a loan of up to $6,300,000 to repay a $750,000 predevelopment/ acquisition loan approved by LIIF and to complete the renovation of the property for educational use. The property, a 74,722 sq ft, six-story former hospital, will serve as the permanent home for Animo Inglewood, a charter high school that opened in Fall 2002.

The project will result in the expansion of Animo Inglewood allowing the school to increase enrollment from 280 9th and 10th grade students to 405 students in grades 9-11 in fall 2004, and 525 students in grades 9-12 by Fall 2005. Renovations to the property will include demolishing interior walls (except for corridor walls); reconstructing restrooms, teacher offices, classrooms, and windows on floors 2-5; and developing administrative offices and a student dining area on the first floor. Renovations are expected to be completed by September 2004.

Animo Inglewood is the second of three charter high schools currently operated by Green Dot, a nonprofit charter school developer incorporated in 2000 that currently operates three schools and will open two additional schools in fall 2004. NCB Development Corporation is participating with LIIF on the loan.

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[1]In California, charters are approved for up to five year terms. Some charters have been able to negotiate “evergreen” charters, whereby each year their authorizer approves them for a five-year term, so they have a rolling five-year charter. But, that is the exception rather than the rule.
[2]Center for Educational Reform, June 2004 (http://www.edreform.com).
[3]Charter School Facilities: Report from a national survey of Charter Schools; Charter Friends National Network and Ksixteen LLC, April 2001 (http://www.charterfriends.org/facilities-survey.pdf).