WASMER SCHROEDER

Charter Schools - Separating the Wheat from the Chaff

November 2019

Once an obscure, misunderstood, fledgling industry, this education sub-sector has seasoned over the past two decades and has established itself as a widely accepted core segment of the muni market. With growing demand, more sophisticated managers and better transparency, Charter schools can represent an attractive relative value opportunity at a compelling spread for both high yield and high grade buyers.

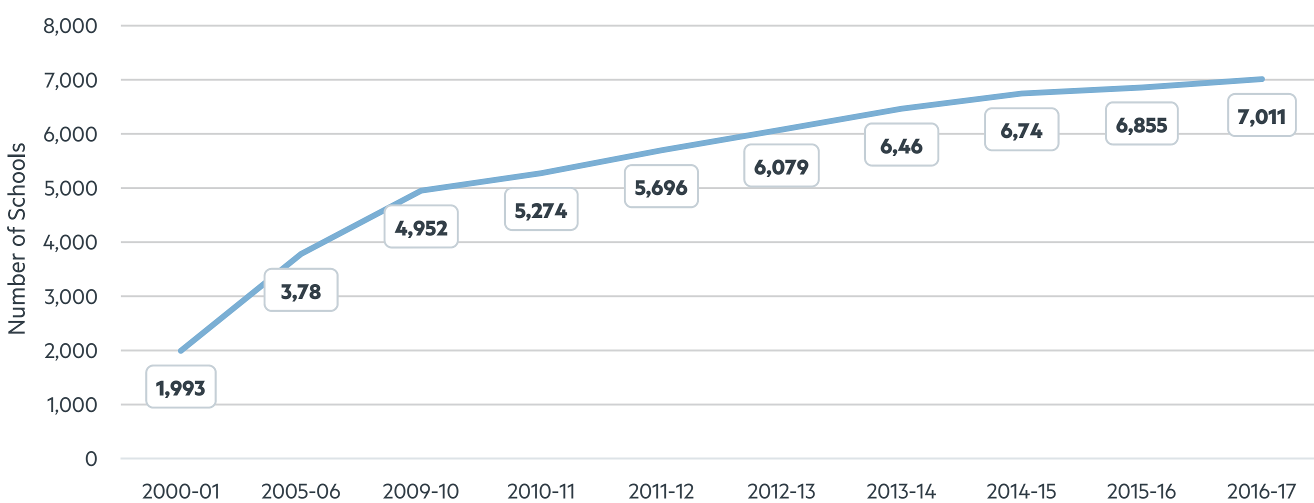
A Brief History

As the header of this primer suggests, we hope to clear up some misconceptions about the role served by charter schools and examine the key criteria and process we undertake when considering these institutions for inclusion into our credit strategy portfolios. For those of you that may not be familiar, charter schools are essentially independently-operated, public schools of choice with the flexibility to offer tailored curriculums and a unique learning environment for grades K-12.

Under state law, the schools are authorized to operate for a specific term under a legal 'charter' that outlines academic goals as well as other performance goals, and sets the parameters for their operation. They are not supported by ad valorem taxes and are non-tuition based. Instead, they receive payment based on a per-pupil funding formula from the state, county or local district where they serve. In exchange for self-governance, charter schools are subject to periodic performance reviews from their state or local authorizing body that have the authority to renew or revoke a school's charter based on academic, financial or other accountability standards.

Since the opening of the first charter school in Minnesota in the early 1990s, the sector has grown rapidly with over 7,000 schools now operating in 44 states and the District of Columbia. No longer a nascent industry, charter schools can be a single site or part of a larger system of schools operating under one or separate charters.

U.S. Charter School Growth (2000-2017)



2000 – 2017; Source: National Center for Education Statistics

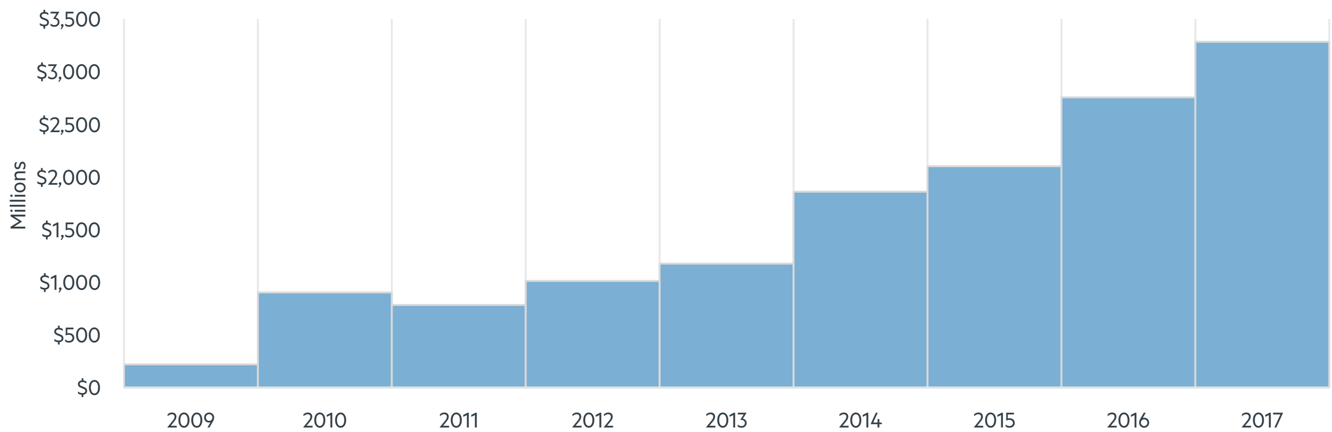
The Opportunity

Since charter schools are not part of the traditional public school system, securing long-term financing can be challenging for a new school. Typically, an opportunity to access the bond market for long-term financing only occurs when a school has established itself with several grade levels and a track record of academic and financial success. Bond proceeds are commonly used to either buy-out the existing lease (purchase the physical assets) or take-out a short-term commercial or developer loan to finance the construction of the facility. Charter schools have competitive cost structures compared to local school districts because they normally hire younger educators, are not subject to collective bargaining and typically don't offer a pension plan; this allows them to operate under a leaner budget that provides the capacity to service their debt.

Because these schools are measured against the performance of other schools in their service area, we focus on market and management intensely and favor institutions with strong leadership and academics along with durable demand statistics in the form of a sizeable waitlist. Prospective investment candidates must exhibit strong stand-alone historical and pro forma financial results with good liquidity and a manageable leverage position - cornerstones of our analysis that provides the confidence to supply capital. Bondholder security should include a pledge of gross revenues, a first mortgage lien on the property and improvements and a cash funded debt service reserve that is essential to maximizing bondholder protections.

Although charter school issuance is still a fraction of the $3.8 trillion tax-exempt bond market it is no longer a small emerging high yield market either. Public bond issuance has grown dramatically over the past decade exceeding $3.0 billion in 2017. In the past, the sector has shown to be resilient through the economic cycle as part of an essential service segment of the market that also meets a proceeds-based positive impact criteria.

Charter School Bond Issuance



2009 – 2017; Source: Bloomberg

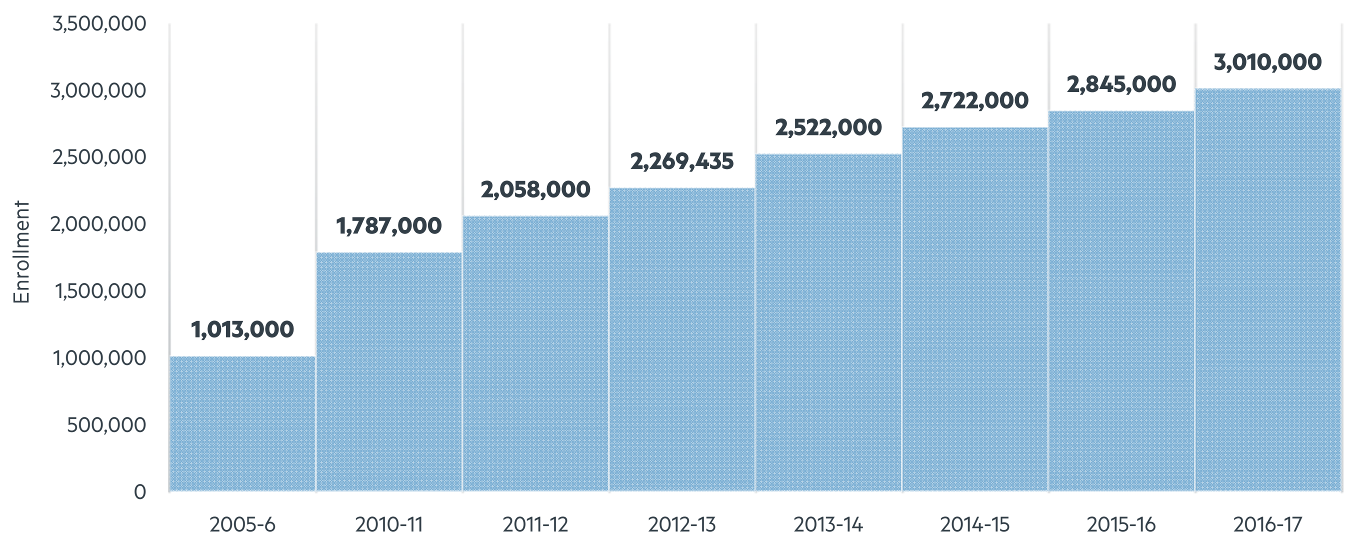
Just about half the charter schools that come to market are non-rated, a segment we underwrite primarily for our high yield strategy and opportunistically across other credit strategies including Short Tax Exempt Credit (STEC), Intermediate Tax Exempt Credit (ITEC), Long Tax Exempt Credit (LTEC). Recent deals have come to market at attractive levels. Depending on credit, bond structure and other technical factors, tax-exempt deals have generally priced between +175-250 basis point spread to AAA Municipal Market Data (MMD), an attractive alternative to generic revenue bond benchmarks.

There are other investment opportunities across the credit quality spectrum ranging from low-investment grade to high-grade deals that are backed by state credit enhancements or guarantees that carry 'AA' or 'AAA' ratings from the public rating agencies. This segment of the market often presents attractive relative value opportunities for our taxable and tax-exempt investment grade credit and strategic portfolios including Strategic Tax Exempt (STEFI), Intermediate Strategic (ISTEFI) and also our taxable Core strategies, Core Bond (CTX) and Core IG Credit (CTX+). Enhanced 'AA' and 'AAA' deals have generally come to market at +55-85 basis points above benchmark AAA MMD that has provided incremental yield and sector diversification to these portfolios. (See sample on following page)

Priced (Week of)	State	Par Amount	Charter School	Ratings: Mdy's/S&P/ Fitch	Final Maturity	Spread to AAA MMD	Yield at Final	30 year Municipal Revenue Bond Yields (BVAL as of 8/28/19)		
								AA	A	BBB
8/12/2019	TX	$17,205,000	Beta Academy	NR/NR/NR	2049	+213	4.00%	2.22	2.42	2.77
8/5/2019	PA	$18,205,000	Alliance for Progress	NR/NR/NR	2049	+218	4.25%	2.22	2.42	2.77
8/5/2019	TX	$91,090,000	Uplift Academy	NR/AAA/NR	2054	+101	3.02%	2.22	2.42	2.77
7/22/2019	TX	$93,350,000	Great Hearts America	Aaa/NR/NR	2054	+85	3.10%	2.22	2.42	2.77
7/8/2019	UT	$40,650,000	Summit Academy	NR/AA/NR	2049	+55	2.83%	2.22	2.42	2.77
6/24/2019	DC	$51,365,000	District of Columbia International School	NR/BBB/NR	2054	+93	3.24%	2.22	2.42	2.77
6/17/2019	NJ	$37,735,000	Beloved Community Charter School	NR/NR/NR	2054	+186	4.20%	2.22	2.42	2.77
6/10/2019	FL	$31,900,000	Advantage Academy	Baa3/NR/NR	2054	+160	3.95%	2.22	2.42	2.77
6/10/2019	FL	$85,980,000	Renaissance Charter School	NR/NR/NR	2049	+242	4.75%	2.22	2.42	2.77

Source: Bloomberg, Municipal Market Analytics

Enrollment Growth (2005-2017)



2005 – 2017; Source: National Center for Education Statistics

What The Future Holds:

School enrollment for charter schools has more than doubled over the last decade due to an increased acceptance by educators and parents and a renewed focus at the state and local level for results driven education reforms that we expect will continue to propel matriculation. At the same time, the sector has benefitted from improved per-pupil funding and larger waitlists nationally that has attracted more sophisticated manager-operators in search of better scholastic outcomes. Overall, the outlook for the charter school movement looks favorable as these schools take a more central role in education reform that will continue to present promising, socially responsible investment opportunities for the disciplined investor.

Mark Kurcon
Vice President, Senior Credit Analyst

Mark Kurcon is a Vice President and Senior Credit Analyst responsible for tax exempt and taxable municipal credit research for Wasmer Schroeder (WS). He has over 25 years of experience in the industry focusing on institutional municipal research and trading.

Mark earned his BS in Finance from Northeastern University and a MBA from Northeastern University. He is a member of the National Federation of Municipal Analysts, Southern Municipal Finance Society.

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.