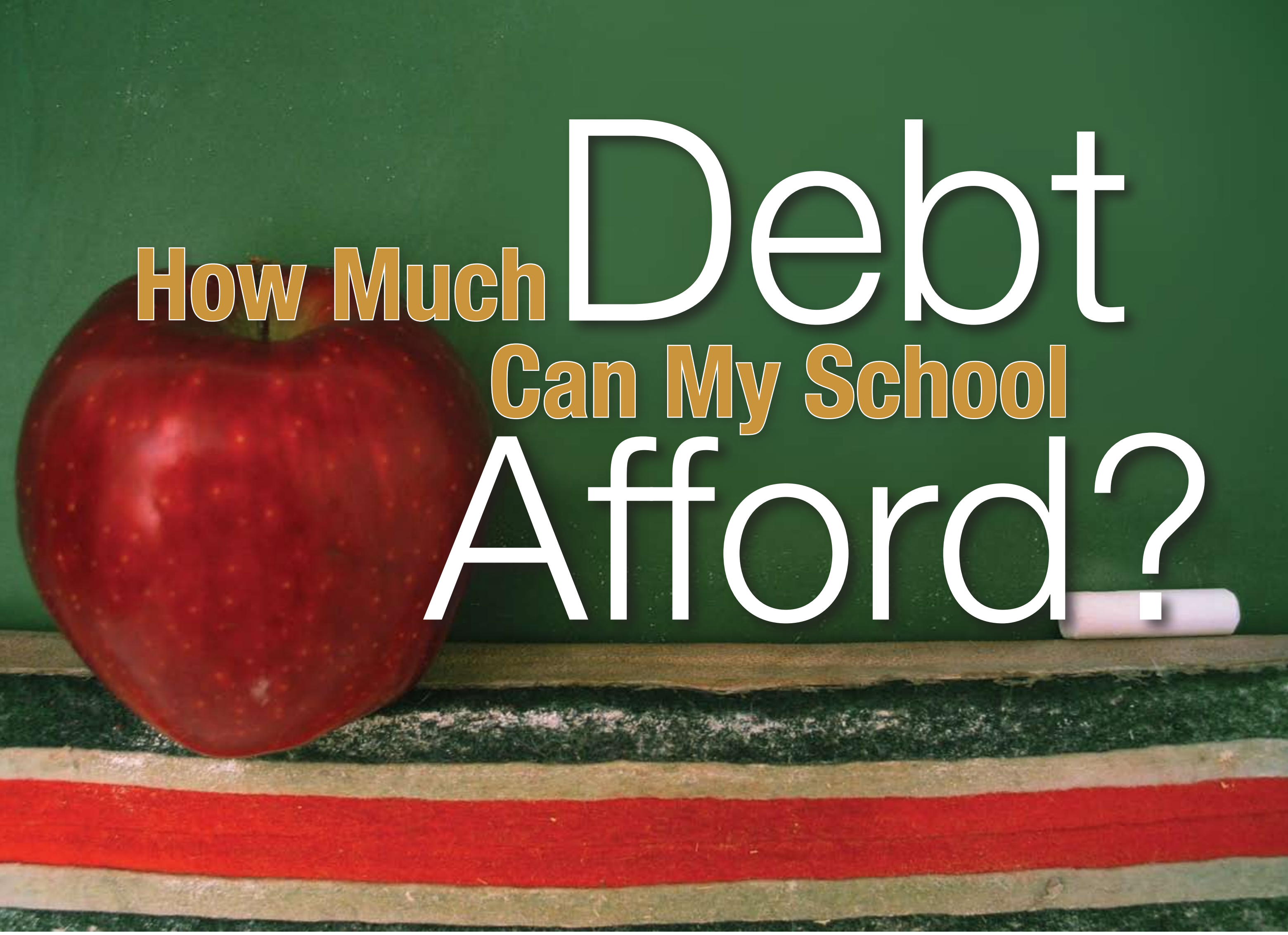

How Much Debt Can My School Afford?

By Michael Braun

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One of the first questions school leadership will ask when they think about borrowing money for a major project is, "How much debt can my school afford?" In order to qualify for this debt, the school or ministry must be able to demonstrate to a potential lender (a bank or bond underwriter) that they can pay the loan or bond issue back over a reasonable period of time.

A thorough analysis of the school's financial and operating history is a key first step in establishing the feasibility and utility of a debt financing for the school. A school is well-served to develop this analysis and determine its "debt capacity" well ahead of working with architects and contractors in designing the building.

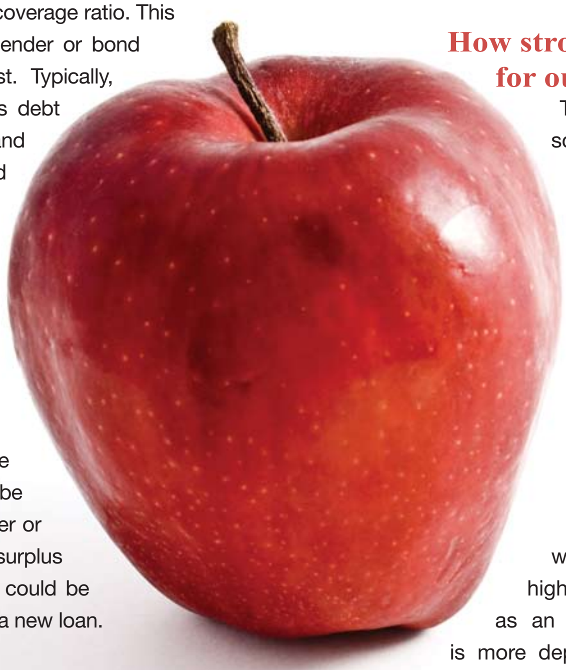
A debt capacity analysis should cover five critical areas to determine the school's overall borrowing ability. These areas include: 1) Total revenue test, 2) Debt service coverage ratio, 3) Loan to value, 4) The impact and importance of fundraising dollars versus tuition dollars, and 5) Quantifying your "demand" through waiting lists. All of these tests are not hard-and-fast rules, but general guidelines. When taken together, they give the borrower a good idea of what size loan they might qualify for.

Do we have critical mass?

The first test in determining a school's borrowing capacity is a test against total revenues. Typically, a lender will do an analysis to ensure that the total annual debt service on a new loan is no greater than 25 percent to 30 percent of a school's total revenues. For example, if the debt service on a new project is $500,000 per year, the lender will want to ensure that the school's total revenues are at least $1,500,000 to $2,000,000 per year. This test really focuses on whether your school has the "critical mass" of students and tuition revenues to support the proposed new mortgage payments.

Do we have enough free cash flow?

The second test in determining a school's borrowing capacity is calculating a debt service coverage ratio. This ratio is the most important when a lender or bond underwriter qualifies a credit request. Typically, lenders will require a 1.10-1.20 times debt service coverage on a historical and projected basis. This ratio is defined as a borrower's unrestricted change in net assets (before depreciation, amortization and interest) divided by annual debt service on the debt. For example, if a school has an unrestricted change in net assets before depreciation, amortization and interest of $750,000; and an annual debt service of $500,000; the debt service coverage ratio would be 1.5 times. This test determines whether or not your organization has a cash flow surplus after paying operating expenses that could be used to make mortgage payments on a new loan.



Are we bringing equity to the table?

The third test in determining a school's borrowing capacity is a loan-to-value ratio. Most lenders will limit the financing amount to be no greater than 80 percent to 85 percent of the real assets being pledged as collateral. For example, if a school has a $10-million-dollar new construction project, a lender will require that the value (as determined by an independent appraisal) of the assets being pledged should be $12.5 million or greater. This value can be in the form of land, existing facilities and improvements associated with the construction project. It is difficult to finance projects when the school is not able to bring "equity" to the table in the form of cash or some pre-existing land or campus value that can be pledged as collateral.

Fundraising dollars versus tuition dollars

The fourth test in determining a school's borrowing capacity is analyzing the impact of fundraising dollars versus tuition dollars. If a school has the ability to fundraise a portion of the project (in either restricted or unrestricted funds) a lender will be more likely to approve the school for a higher loan amount. The ability to fundraise can signify to a lender a higher level of parent and community support for the project. While it's more difficult to quantify the actual impact of fundraising dollars, the old adage of "the more the better" is certainly true in this case. Most successful building projects require a significant fundraising and gift development component in addition to a strong tuition base.

If your school is sponsored by a church, in some instances, the school may receive ongoing operational or capital expense subsidies from the church. While these are not technically fundraising dollars, they can be an important component for many schools in allowing them to operate and fund new construction projects as they provide an additional revenue stream to complement tuition revenues.

How strong is the demand for our school?

The last test in determining a school's borrowing capacity is the school's ability to quantify demand through a waiting list. A strong demand quantified through a waiting list signals to the lender that the school's operations are strong and are likely to grow in the future. Often, the idea of a new project is spurred by a growth in enrollment and, ultimately, a waiting list. With this in mind, many lenders will utilize a five-year forecast that highlights this growth in enrollment as an underwriting tool. If a project is more dependent upon future growth in enrollment to meet its debt service obligations, a waiting list can help eliminate the demand risk and allow the lender to underwrite this forecast more reasonably.

In conclusion, there are many facets to a debt capacity analysis. Some of these are easier to quantify and identify from your school's historical financial performance than others. By understanding the total revenue test, your debt service coverage ratio and the loan-to-value on a project, you can make better decisions when it comes to finalizing a project budget and spending money on architectural work. Further, when you add fundraising dollars and a strong waiting list to the equation, your school should gain comfort in the overall feasibility of the project, and ultimately, your ability to cover the debt service on a new mortgage.

Since some of these tests are subjective, we encourage your organization to seek out a qualified private school lender or bond underwriter early-on in the process to discuss a debt capacity and borrowing potential. A specialized lender can help you shape a realistic project that has a strong probability of being funded.