DETERMINING YOUR SAFE DEBT CAPACITY

One of the first questions charter school leadership should ask when considering a major project is, "How much debt can my school afford?" This question should be asked early to avoid beginning design work for a new facility, only to find that the project budget is out of reach. In order to qualify for financing, schools must be able to demonstrate to potential lenders (banks or a bond underwriter) that they can pay their loans or bonds back over a reasonable period of time without straining their financial resources.

A thorough analysis of a school's financial and operating history is a key first step in establishing the feasibility of a debt financing for the school. Debt load relative to enrollment and revenues is a useful analysis for establishing guidelines for a reasonable amount of debt and annual debt service payment. Historical and projected debt service coverage calculations can help refine the reasonable debt service payment target. A review of demand is also important, particularly for projects that involve enrollment growth. Finally, loan-to- value is a common ratio used in lending, although it is less important if tax-exempt bonds are issued. These tests are not hard-and-fast rules, but general guidelines. When taken together, they can give a school a good idea of its reasonable borrowing capacity, which informs the project budget.

IS THE PROPOSED FUNDING AMOUNT REASONABLE?

One of the first steps in determining debt capacity is to look at the size of the school. This is done in two ways—enrollment and operational revenue. For enrollment, we use a "debt per student" test, taking the proposed borrowing amount and dividing that by enrollment. For projects that will add to your enrollment capacity, enrollment is stabilized enrollment after you have filled up your new building. Lenders are generally looking for debt-per-student to fall around $15,000-$20,000, so for early stage projects, reversing the calculation— taking the target stabilized enrollment and multiplying by $15,000 to $20,000—can provide a rough guideline for a reasonable borrowing target. Example, if your school is looking to reach a maximum enrollment of 1,000, a rough maximum borrowing number would be $15 million to $20 million ($15,000 ($20,000) x 1,000 students).

It is important to keep in mind the limitations of this test. Although $15,000 of debt per student can be useful as a preliminary guideline, lenders vary considerably on what they consider a reasonable number. Additionally, this number will vary for each school and each project. For example, real estate values vary across the country, making average project costs higher in some areas—a factor lenders take into account. Additionally, the amount of debt-per-student that a school can support is highly dependent on per-pupil reimbursement levels. This can vary considerably for example, funding tends to vary by state and district, by grade level, special needs and other factors according to local reimbursement rules.

One tool lenders have to account for funding variances is to compare the schools revenues to the proposed debt payment. Typically, lenders use this analysis to ensure that the total annual debt service on a new loan is no greater than 15 percent to 20 percent of a school's total revenues once the school reaches enrollment stabilization. For example, if the debt service on a new project is $600,000 per year, the lender will want to ensure that the school's total revenues are at least $3,000,000 to $4,000,000 per year. Again, this test is useful as a guideline, but the acceptable levels can vary between projects and between lenders.

DO WE HAVE ENOUGH FREE CASH FLOW?

In order to narrow down the debt capacity for a specific project, it is helpful to calculate projected and historical pro-forma debt service coverage ratios. This ratio is defined as a borrower's adjusted change in net assets (before depreciation, amortization and interest and including adjustments for non-cash and extraordinary items) divided by annual debt service on the proposed debt. For example, if a school has an adjusted unrestricted change in net assets of $750,000 and an annual debt service of $500,000, the debt service coverage ratio would be 1.50 times. Typically, lenders will require a 1.10-1.20 times debt service coverage on a historical and projected basis. For the historical coverage, debt service on the proposed debt is used. For projects that are contingent on growth (e.g. opening a new campus), historical coverage may not be required if a school is able to demonstrate strong demand that will fill up any newly constructed or acquired building.

HOW STRONG IS THE DEMAND FOR OUR SCHOOL?

For growth projects, a key consideration for borrowing capacity is the school's ability to quantify demand through application and enrollment statistics and a waiting list. A history of enrollment growth and a solid waiting list signals to the lender that the school's operations are strong and are likely to grow in the future. This is especially important for projects that are predicated on future enrollment growth. With this in mind, many lenders will utilize a five-year forecast that highlights this growth in enrollment as an underwriting tool. Even if the project is not contingent on future growth, a strong waitlist and strong application and matriculation numbers help illustrate a school's ability to maintain enrollment or add students if funding is unexpectedly reduced.

ARE WE BRINGING EQUITY TO THE TABLE?

One further test in determining a school's borrowing capacity is a loan-to-value ratio. Many lenders will limit the financing amount to between 60 percent and 80 percent of the real assets being pledged as collateral (60 to 80 percent loan-to-value, or LTV). 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 important to note that tax-exempt bond investors have shown willingness to fully-fund new projects for charter schools, meaning that schools issuing tax-exempt bonds may not be required to have equity in the project (i.e. debt may be issued at 100 percent LTV). **Ziegler has successfully financed many charter school projects at 100% of the cost without needing specific equity contributions**.

In conclusion, there are many facets to a debt capacity analysis. A debt capacity analysis is allows schools to make better decisions when it comes to finalizing a project budget and spending money on architectural work. Meeting the various guideline levels and maintaining a strong waiting list should give schools comfort in the overall feasibility of their projects, and ultimately, their ability to cover their debt service obligations. Again, these are only guidelines, however, and there are other factors that can impact debt capacity, including fundraising and third-party guarantees.

We encourage your organization to seek out a partner like Ziegler early-on in the process to discuss debt capacity and borrowing potential. For a free, in-depth debt capacity analysis, please email us at srolfs@ziegler.com or call us at 800-558-1776 for more information.