

## Charter Schools: A Unique Tax-Exempt Private Credit Opportunity

Charter schools have been the most enduring and impactful innovation in public education in the last 30 years. The very first charter school, opened its doors in St Paul, Minnesota to 53 students in 1992. Driven by parental demand for more and better school options, during the 2022-2023 school year, charter schools enrolled approximately 3.8 million students in over 8,000 campuses across 44 states, two US territories and the District of Columbia. With laws now allowing for their creation in 46 states, Washington, D.C., Guam and Puerto Rico, the demand for high quality charter schools is increasing.<sup>1</sup>

A critical factor limiting growth is the fact that charter schools are responsible for funding and securing their own facilities. While well-established charter schools can access the \$5 billion tax-exempt public bond market, capital for early-stage and start up charter school facilities is sorely lacking.<sup>2</sup>

As an investment, charter school facility bonds offer attractive tax-exempt yields with reduced systemic risk.<sup>2,3,4,5,6</sup> Leveraging our team's decades of experience working in and for charter schools, we've made tax-exempt facility finance for these underserved charter schools the cornerstone of our K-12 Education strategy.

### Charter Schools and Presidential Elections

A question we are frequently asked is: "What impact would a (Presidential Candidate) Administration have on charter schools?" The simple answer is "Little or None." A more complete answer requires us to better define what charter schools are as well as the macro environment in which they operate.

#### What are Charter Schools?

Charter schools **are public schools** that operate under the control of a not-for-profit board rather than a school district. Charter schools are free and open to any student within their catchment area (typically the school district in which they are located but may be the entire state). Like all public schools, charter schools are funded by a mix of state, local and federal revenues. Charter schools, however, receive "per-pupil funding" based on the number of students they enroll as opposed to other public schools which have all their expenses (salaries, benefit, facilities, etc.) paid directly by the school district.

Charter Schools exist to provide an alternative when district public schools are either failing or parents feel they are not providing their children with adequate education opportunities. They may not have any form of admissions testing and must admit students via lottery when enrollment applications exceed seats available. No student

is ever required to attend a charter school, rather, parents must choose to enroll there. Should parents be unhappy with a charter school, they are free to return to their local district school.

All charter schools operate under a contract (or “charter”) with an “authorizer” (typically the state, a school district or university) that holds them accountable to the high standards. Charters are for a fixed term (typically 5 or 10 years) and must be renewed at the end of the term to remain in operation. Charter schools create their own school model, for example: College Prep, STEM or the Arts, and offer a curriculum of their choosing, but students are still required to participate in all statewide standardized testing. They also have the freedom to establish policies, set their own school calendar and schedule, and hire and fire staff and teachers to best meet the needs of their students. In essence, charter schools are given autonomy in exchange for accountability.

#### How many charter schools and students are there?

During the 2022 - 2023 school year, charter school enrollment was 3,763,812 or 7.58% of all public education students in the United States.<sup>1</sup> That same year, 327 new charter schools across the nation opened their doors, bringing the total number of campuses to 8,150.<sup>1</sup> During the COVID pandemic (Spring 2019 – Spring 2023), while total U.S. public schools saw a loss of approximately 1.2 million students, **charter school enrollment grew by 306,432.**<sup>1</sup>

#### Where are charter schools located?

As of November 2024, 46 states, Guam, Puerto Rico, and Washington D.C. have laws permitting charter schools. Kentucky passed a charter school funding bill in 2022, which will enable charter schools to open in the future; however, no charter schools have opened there as of yet. They are found within the geographic confines of only 14.2% of local school districts, meaning they are highly concentrated in certain areas.<sup>1</sup> States with the most charter schools are: California (1312), Texas (1053), Florida (743), Arizona (584) and Michigan (378). Cities with the greatest charter school enrollment are: Los Angeles (150,872), New York (139,608), Miami (80,792) and Philadelphia (65,128).<sup>1</sup>

#### Who do charter schools serve?

Initially envisioned only as an alternative for failing urban schools, charter schools can be found in many types of communities across the nation. While the majority of charter school students are still located in urban communities, 28.8% are suburban, 10.8% are rural and approximately 3.7% are in locations classified as “other,” such as small townships, military bases and tribal communities.<sup>1</sup> Charter schools disproportionately serve low income (61.4%) and minority students (71.7%).<sup>1</sup>

## So why don't Presidential Elections impact charter schools?

It is a widely held misconception that the federal government funds a significant portion of K-12 education. K-12 Education in the United States largely falls under the control of state and local governments. The U.S. Constitution lays out a limited set of responsibilities for the federal government and reserves to the states and the people, all responsibilities beyond those enumerated powers. Education isn't mentioned anywhere in the Constitution, so the American education system is famously and uniquely decentralized with control over the day-to-day operation of schools in the hands of roughly 14,000 locally elected or appointed school boards.<sup>7</sup> As a result, federal dollars make up the smallest portion of the three major funding sources for public education in the United States.

Excluding the COVID-19 “pandemic relief” for FY 2020, in the decade prior, federal funding made up slightly less than 8% of K-12 education funding, with state (48%) and local (45%) funds making up the rest.<sup>8</sup> Based on available data, we've seen a return those percentages post-pandemic.<sup>9,10</sup> Additionally, the majority of federal K-12 education funding is not meant for the classroom, rather it comes from U.S. Department of Agriculture Child Nutrition programs (National School Lunch and School Breakfast programs) under laws in place since the late 1940's.<sup>8</sup> Funding from the U.S. Department of Education comes, primarily, as formulaic grants.<sup>8,11,12</sup> These grants are largely administered by the states and based on laws originating prior to the creation of the U.S. Department of Education in 1979. In FY 2022, the Every Student Succeeds Act (ESSA), originally enacted as the Education and Secondary Schools Act in 1965, provided \$15 billion in formulaic grants to K-12 schools under the Title I program to support disadvantaged students.<sup>8,11</sup> That same year, K-12 formulaic funding under Part B of the Individuals with Disabilities Education Act (originally enacted in 1975, for students with special needs) totaled \$12.5 billion.<sup>8,12</sup>

Putting this into perspective, total expenditures for K-12 public education in FY 2022 were approximately \$813.6 billion. On average, that meant \$15,188 was spent per public education student in the United States. On a per student basis, that equates to \$559 (3.68%) from the U.S. Department of Education, \$589 (3.88%) from the U.S. Department of Agriculture with \$14,040 (92.44%) from state and local funding sources.<sup>8,9</sup>

In this regard, charter schools are no different than any other public school. State and local sources make up the vast majority of their funding as well as federal Title I, IDEA Part B and USDA Child Nutrition program funding for those students who qualify. The only additional federal funds for which charter schools may qualify are U.S. Department of Education Charter School Program (CSP) grants, which are selectively awarded to assist with costs associated with starting, replicating or expanding charter schools. CSP grants are limited in both their dollar value and the

life-cycle of a charter school. They make a very small portion of overall funding for charter schools.<sup>13,14</sup>

## Questions We Believe Investors Should Be Asking

### Why is there a need for charter schools to finance facilities?

Charter schools are responsible for funding and securing their own facilities. While unoccupied or underutilized school facilities are available in some areas, it is the exception, not the rule. Commercial leasing with owner financed tenant improvements can be a solution, but the availability of compatible real estate as well as the common requirement for annual rent escalation can make this unfeasible, particularly in fast-growing communities. New construction or purchasing and repurposing commercial buildings are often the best (or only) options available to charter schools.

### How are charter school facilities financed?

Traditional commercial lending is typically not available to charter schools. Banks are highly regulated, and certain aspects inherent to charter schools are incompatible with commercial real estate underwriting such as: high loan-to-value ratios, a need for loan amortizations that exceed the term of the charter and a lack of comparable facilities for appraisals. As a result, the tax-exempt public bond market has become the primary tool of long-term finance for established charter schools. The largest tax-exempt bond fund managers (e.g. Nuveen, Blackrock, Invesco, etc.) view charter school facilities as stable assets supported by a consistent stream of government cash flows. Since the issuance of the first tax-exempt charter school revenue bond in 1998, the market grew from \$35,000,000 to more than \$5,000,000,000 annually by 2021.<sup>2</sup> In recent years, as much as \$840 million of the total charter school bond market has been for start-up and early-stage charter schools with unique risks that require investors like 503 Capital who are willing to purchase the entire offering.

### On what risks facing charter schools **should** investors be focused?

We see very low systemic risk in the broader market for charter schools. A free and public K-12 education is a right guaranteed by all state constitutions, supported by dozens of federal laws and backed by decades of legal precedence. State funding of primary and secondary schools is not optional; it is a requirement. As a result, the systemic risk of charter school facility bonds is significantly lower than that of the wider market for stocks and bonds.<sup>2,3,4,5,6</sup> This was validated during the COVID-19 pandemic. Despite extraordinary financial and social turmoil, where students were kept out of classrooms for as long as 18 months, in nearly all cases, charter school revenues saw significant increases. This was the result of the massive federal Emergency Elementary and Secondary School Emergency Relief (ESSER) program.<sup>15</sup> While state tax revenues decreased precipitously<sup>3</sup> and the wider market crashed,<sup>4</sup> US

public schools, including charter schools, proved to be highly insulated from the risks experienced in the general market. It is notable that charter school bond defaults declined (rather than the general assumption that they would increase) throughout the pandemic (March 2020 – December 2022).<sup>6</sup>

503 Capital Partners believes the real risks in the space are at the individual level for each investment opportunity. Those risks fall into four broad categories:

**1. Enrollment Risk:** As previously mentioned, no student is ever required to attend a charter school. Rather, parents must choose to enroll there. Should parents be unhappy with a charter school, they are always free to return to their local district school or try some other option. Charter schools must attract and retain students if they are to receive per-pupil funds adequate to pay salaries and benefits, all operating expenses, cover debt service and do so with enough of a surplus to provide the days cash on hand required to handle any unplanned expenses or funding delays. This is often something new for school leaders, who often have managed budgets, but rarely experienced profit and loss accountability. Furthermore, while some expenses can be reduced if necessary, increasing enrollment is the only real lever school leaders have to increase revenues. In the case of startup or charter school expansion, they must also dedicate the time and resources needed to grow their enrollment.

**Mitigation Strategy for Enrollment Risk:** We believe there are two primary ways to mitigate enrollment risk. The simplest method is to run a demographic analysis to ensure that there are enough children in the age-based population of that particular catchment area that filling the school won't be the problem. Having the experience that we do in the education space, we know the particular percentages of a target population that we are looking for to determine if there are enough children to fill the seats. That brings us to the next mitigant – the importance of having a great operator. We are overly diligent in choosing operators and educators with a strong historical track record - indicating they can ensure children are well-taught while simultaneously demonstrating revenues and expenses are handled properly. We also analyze the competitive set of schools in a particular market, as well as the available school models and curricula to ensure that enrollment demand for a charter school's unique offering isn't already being met by other schools in their market.

**2. Charter Non-Renewal Risk:** Charter schools operate under a contract, or charter, with an authorizer (typically the state, a school district or university) that holds them accountable to high standards. Charters are fixed-term contracts, typically 5 or 10 years, which must be renewed at the end of the term to remain in operation. Authorizers play an important role in the charter sector. These entities decide whether an initial charter should be granted and the standards to which the

school will be held accountable. Charter agreements typically contain requirements for compliance with applicable state and federal laws, reporting (e.g. board minutes, budgets, annual audits, etc.) and financial performance. All charter agreements have academic requirements, typically using statewide standardized test data (student academic growth and proficiency) which are measured against local school district and statewide benchmarks. Based on these factors, an authorizer will make a determination whether or not to renew a charter. In some cases, an authorizer may decide to renew a school's charter conditionally or for a reduced term. It is important to note, however, that nearly all charter laws specify that charters must be renewed unless the authorizer has evidence that a school has failed to meet renewal requirements. Charter laws also contain provisions for charter school to appeal a non-renewal.

**Mitigation Strategy for Non-Renewal Risk:** During our underwriting process, for any prospective investment, 503 Capital analyzes each particular authorizer regarding their ongoing individual school relationships for those whom they have extended an authorization as well as their track record of charter issuances and non-renewals. There are many authorizers in the space for which we have a tremendous amount of respect, and typically we are repeatedly issuing debt to schools within their portfolio as we are comfortable with that track record. There are other authorizers, new to the space or with track records of avoidable conflicts and non-renewals, that we tend to avoid. Understanding the authorizer is an important part of our underwriting process.

- 3. Project Risk:** There are risks inherent to all real estate development, construction and/or renovation projects. These include but are not limited to: entitlements, zoning, permitting, contracts, escalating costs, project delays, general contractor surety and occupancy inspections.

**Mitigation Strategy for Construction Risk:** While pre-development risk is often lumped in with construction risk, they are extremely different. In pre-development, one takes on the risk that proposed site may or may not be approved for construction of the prospective school. 503 Capital does not take on any pre-development risks such as zoning, entitlements and permitting. We will not close until we have assurances that those particular hurdles of an investment have been cleared, and everything is in place for construction to commence.

In our process, we underwrite the developers and general contractors (and often major subcontractors) involved to ensure they have a track record of delivering school facilities on time and on budget. There are quite a few developers and general contractors who've built multiple schools that we have financed, which gives us even greater confidence in the project. Additionally, we build contingency into our financing that goes beyond that in the underlying

construction contract to handle unforeseen challenges that may arise. We also require projects to be bonded to mitigate the financial risk of those involved in the construction process.

- 4. State and Local Political Risk:** Support for charter schools is generally strong, especially among Black and Hispanic families. In a 2022 Harris Poll of parents across the nation, 77% indicated they would like to see more public charter school offerings in their area. Furthermore, these findings were consistent across political affiliation.<sup>16</sup> Charters Schools have also enjoyed broad bipartisan political support, ranging from the White House, to Congress, to governors' mansions, to state legislatures.

Public schools, however, are inherently political. This very much includes charter schools, as they too are public schools. Furthermore, schools are key components in the social infrastructure of local communities. They have the potential to arouse great passion in parents and neighbors, as anyone who has ever attended a local school board meeting can attest. School districts tend to be one of the largest employers in a community, and teacher unions can be one of the most powerful political interest groups in a state.

Charter schools are often viewed as a threat by neighboring schools and local school districts. While arguments that charter schools are not public schools<sup>17</sup>, that they take money away from district schools<sup>18</sup>, that they “cream” the best students from district public schools<sup>19</sup>, and that they are not held accountable to the same standards as district school<sup>17</sup> have been debunked, these arguments can be very persuasive when presented to elected officials. Per-pupil funding rates for charter schools are set by the state. The time and actual flow of funding is controlled by the state and, in some cases, local school districts. Legal, regulatory and reporting requirements for charter schools are set by state, and often local, elected and bureaucratic officials. All of these can have a profound impact on charter schools' ability to focus and execute on their mission to provide the best possible education to their students.

**Mitigation Strategy for Political Risk:** While 46 states, the District of Columbia and 2 US territories have laws authorizing charter schools, we have chosen to concentrate our efforts on roughly ten states – with a particular focus on Arizona, Colorado, Florida, North Carolina, South Carolina and Texas. It is our assessment that the combination of their growing populations, financial stability, charter school laws and regulatory environments, as well as a culture of parental demand for school choice, offers the best opportunities for our investors. We do consider compelling charter school financing opportunities in other states (there are currently charter schools from 11 states in our portfolio), but those are more

opportunistic plays, typically with existing schools that have a long history of success.

Clustering charter school investments can be a risk mitigation strategy in itself. While it flies in the face of the general CFA rule that demands geographic diversity, by focusing on particular markets, we better know the players in the space: authorizers, associations, operators, developers, etc. and understand the legislative and political landscape. In the event of an operational failure, having these relationships gives us the greatest probability of finding another charter school management organization to take over the day-to-day operations of the school, ensuring the needs of the students are met while protecting our investment in the facility. Replacing an operator, rather than selling an empty school building, increases the probability of capital recovery if an investment is impaired.

### How does 503 Capital Partners Employ These Mitigation Strategies?

**Our Underwriting Process:** Our K-12 origination team evaluates scores of charter school facility finance opportunities each year. From these about a dozen receive intensive vetting to include meetings with school leaders and board members, a deep dive financial analysis, an assessment of the local community, a determination of the school's ability to differentiate itself in order to create enrollment demand, an understanding of potential competition from neighboring schools and general feasibility of the project.

When a term sheet is issued, the opportunity is turned over to the credit team where it goes through intensive credit analysis, credit diligence and independent validation - including a site visit and meetings with school leaders and board members. These results are then presented to our Investment Committee that gives the ultimate approval or denial. Finally, in structuring, legal due diligence and closing, all project contracts, security and collateral protections, call/put provisions, and tax opinions, are thoroughly scrubbed and executed. In the six years our team has been together, we've closed approximately \$450,000,000 of the more than \$5 billion in school opportunities evaluated, with zero defaults.

**Asset Management:** Throughout the life of the investment, we maintain regular contact with the school. All required continuing disclosure is publicly posted on the MSRB's Electronic Municipal Market Access (EMMA) site. We proactively work with school leaders and/or board members to quickly resolve any issues that arise that could result in covenant violations or delays in debt service payments. In the event financial or operational covenants are violated, a consultant may be put in place to assist the school with any impairments. If necessary, our Head of Asset Management

may put forbearance agreements in place, or in the worst case, find another charter or education management organization to take over operations or purchase the property.

**Experience:** Our education team has more than 60 years' experience working in the Charter School segment of the K-12 Education sector in a wide variety of roles: investing, banking, development, school leadership, advocacy and board membership. We also have over 20 years of workout expertise in-house to resolve challenges before they result in investment losses. In the course of our careers, we've closed more than \$2 billion in charter school transactions. Since our investment philosophy can be described as "an inch wide and a mile deep," our education originators work exclusively with K-12 charter and private schools. Collectively, we've met with nearly a thousand charter school leaders and board members in states across the nation. We've done tours and conducted site visits at well over 200 charter schools. We keep current on the political and demographic landscape for the states and communities in which we invest. Most importantly, we know that all successful charter schools are built on a foundation of exceptional school leadership and governance, and there is no substitute for experiencing a school's culture first-hand.

<sup>1</sup> **Knowledge Base**, National Alliance for Public Charter Schools. <https://data.publiccharters.org/>

<sup>2</sup> TM3, Bloomberg, Investment Company Institute

<sup>3</sup> **How Did State and Local Governments Fare During the Pandemic?**, US Government Accountability Office; August 3, 2021. <https://www.gao.gov/blog/how-did-state-and-local-governments-fare-during-pandemic#:~:text=Together%2C%20state%20and%20local%20government,through%20the%20remainder%20of%202020>

<sup>4</sup> **What Was the COVID-19 Stock Market Crash of 2020? Causes & Effects**, L. Rodini, The Street; November 10, 2022. <https://www.thestreet.com/dictionary/covid-19-stock-market-crash-of-2020>

<sup>5</sup> **Muni monitor series: Back to School Edition**, D. Close and M. Kleinmann, Nuveen; September 2024.

<sup>6</sup> **2022 Charter School Bond Sector Default Study, Default and Loss Rates Continue to Decline**, W. Berry, Equitable Facilities Fund; November 21, 2023.

<sup>7</sup> **Unpacking the U.S. Department of Education: What Does It Actually Do?** Harvard Graduate School of Education EdCast. <https://www.gse.harvard.edu/ideas/edcast/25/02/unpacking-us-department-education-what-does-it-actually-do>

<sup>8</sup> **How is K-12 Education Funded?**, Peter G Peterson Foundation, August 19, 2024. <https://www.pgpf.org/article/how-is-k-12-education-funded/>

<sup>9</sup> Digest of Education Statistics. Retrieved May 28, 2025.

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<sup>10</sup> **Department of Education Fiscal Year 2024 President's Budget Request**. <https://www.ed.gov/about/ed-overview/annual-performance-reports/budget/budget-requests/presidents-fy-2024-budget-request-for-the-us-department-of-education>

<sup>11</sup> **The Elementary and Secondary Education Act (ESEA), as Amended by the Every Student Succeeds Act (ESSA): A Primer**. <https://www.congress.gov/crs-product/R45977>

<sup>12</sup> **The Individuals with Disabilities Education Act (IDEA), Part B: Key Statutory and Regulatory Provisions**. <https://www.congress.gov/crs-product/R41833>

<sup>13</sup> **The Charter Schools Program 2023 Impact Report: A modest federal investment with strong returns for students**; National Alliance for Public Charter Schools, May 2023.

<sup>14</sup> **National Charter Schools Week 2025: Celebrating 30 Years of Impact through the Charter Schools Program**; Press Release, National Alliance for Public Charter Schools, May 12, 2025. <https://publiccharters.org/news/ncsw25-media-release/>

- <sup>15</sup> **Pandemic Oversight**, Council of Inspectors General on Integrity and Efficiency. <https://pandemicoversight.gov/data-interactive-tools/data-stories/states-received-1895-billion-relief-schools-heres-breakdown#:~:text=School%20closures%20and%20online%20learning%20during%20the,states%20are%20distributing%20the%20funding%20to%20public%20>
- <sup>16</sup> **Never Going Back: An Analysis of Parent Sentiment in Education**. National Alliance for Public Charter Schools; August 2022.
- <sup>17</sup> **The Truth About Public Charter School Success**, Texas Public Charter School Association; 2020.
- <sup>18</sup> **Think Again: Do charter schools drain resources from traditional public schools?**, D. Griffith, Thomas B Fordham Institute; March 2023.
- <sup>19</sup> **Charter schools outperform traditional public schools on average. Here's why**, M.Pertilli and D. Griffith; August 29, 2024. <https://fordhaminstitute.org/national/commentary/charter-schools-outperform-traditional-public-schools-average-heres-why#:~:text=Nor%2C%20according%20to%20multiple%20studies,go%20far%20beyond%20test%20scores.>

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