



Governor's Office of

Strategic Planning and Budgeting

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Douglas A. Ducey
Governor

Matt Gress
Director

DATE: September 5, 2019

TO: Credit Enhancement Eligibility Board

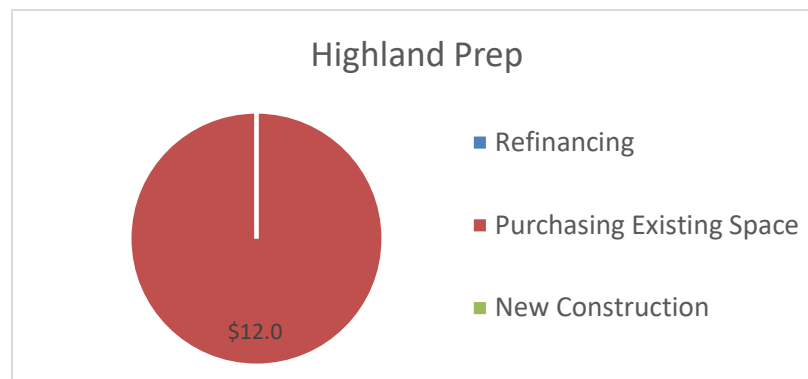
THRU: Matt Gress, Director, Governor's Office of Strategic Planning and Budgeting

FROM: Sarah Giles, Senior Budget Analyst, Governor's Office of Strategic Planning and Budgeting

SUBJECT: Highland Prep – Application for the Public School Credit Enhancement Program

Summary of the Request

Highland Prep (HP) has applied as an Achievement District School and for participation in the Public School Credit Enhancement Program for up to \$12.0 million in proposed financing. In summary, HP requests enhancement for about \$10.5 million in new debt that will be used to purchase its existing charter school campus in Surprise, \$250,000 for furniture and equipment, and \$1.2 million for the required debt service reserve fund and other costs related to the issuance. The proposed financing will enable HP to stabilize facility expenses and admit 115 waitlisted students (see Impact of Proposed Financing).



Based on staff review, Highland Prep meets the requirements to qualify for the Public School Credit Enhancement Program.

Recommendation

The Board has at least the following two options regarding HP's application as an Achievement District School:

1. Approval as an Achievement District School (**Staff recommendation**).
2. Denial of the application to qualify as an Achievement District School.

If the Board does not approve the Achievement District application, Highland Prep is not eligible for the Public School Credit Enhancement Program. If the Board approves the Achievement District application, the following three options are available for the Board to consider:

- A. Approval of credit enhancement for the full amount of the proposed financing of \$12.0 million.
- B. Approval of credit enhancement for an amount that is less than the full amount of the proposed financing.
- C. Conditional approval of credit enhancement for either the full amount of the proposed financing of \$12.0 million or an amount that is less than the full amount pending the obtainment of an underlying credit rating of BB-.
- D. Denial of credit enhancement for any portion of the proposed financing.

Approval of credit enhancement of any amount is subject to the applicant's execution of the Terms and Conditions Agreement and Reimbursement Agreement prior to the issuance of a Fund Certificate, which will confirm the guarantee of timely payments of principal and interest on the financing.

Analysis

Applicant Overview

HP holds a standalone charter with the Arizona State Board for Charter Schools, but is considered an Associated Charter with Madison Highland Prep (MHP) because they share at least 50% of the same members on their respective governing boards. HP is located in Surprise, Arizona and opened in FY 2018. MHP is located in Phoenix and opened in FY 2015. HP enrolled 218 students in grades 9 and 10 in school year 2018-2019 and projects 344 students will be enrolled in school year 2019-2020 as HP expands to grade 11. According to the application, HP and MHP are Science, Technology, Engineering and Math (STEM) college-preparatory high schools that emphasize student preparation for success in an increasingly innovation-driven society and global marketplace. The applicant reports that students' passing scores on the 2018 AzMERIT test were 78% for English Language Arts and 84% for Math compared to the statewide average of 41% in both subjects. The applicant also reports that its Associated Charter, MHP, has a 100% College and Career Readiness Rating and 100% Graduation Rate in 2019 from the Arizona Department of Education.

Application Details:

Date Received: 7/11/2019

Date Complete: 8/6/2019

Deadline to Approve/Deny: 10/6/2019

Applicant Contact: Kerry Clark

Borrower's Counsel: Warren Charter Law, PLC

Bond Counsel: Engelman Berger, P.C.

Underwriter: B.C. Ziegler and Company

Bond Issuer: Maricopa IDA

Achievement District Qualification

A.R.S. §15-2141 establishes criteria that an applicant must meet to qualify as an Achievement District School. Based on the review of documents provided by HP in their application, Staff believes HP has met the criteria established in statute.

Requirement	Status
Assigned a letter grade of A, or an equivalent successor classification	Per ADE policy, schools in 1 st year of operation are not assigned a letter grade. However, HP would have qualified as an “A” school under the letter grade system in school year 2017-2018.
Proven instructional strategies and curricula that demonstrate high academic outcomes	Materials Provided
Verifiable enrollment demand, including the placement of prospective pupils on a waiting list	Attestation of 115 students on waitlist at HP
Sound financial plan that contemplates operational costs and future enrollment growth	Financial Documents
Commitment to provide technical assistance to an underperforming school	Partnership with Victory Collegiate Academy

At the time of application, HP reported a wait list of 115 potential students based on expressed intent to enroll. HP has partnered with Victory Collegiate Academy (VCA), an underperforming charter school in Phoenix, to provide student tutoring, consulting services on best practices in STEM education, and STEM professional development for VCA staff. At HP, 38% of students qualify for free or reduced-price during school year 2018-2019, compared to 43% of high school students in the Dysart Unified School District, also in Surprise.

Impact of the Proposed Financing

HP currently leases its 35,244-square-foot high school campus in Surprise with capacity for 520 students and currently enrolls 344 students. The proposed financing includes about \$12.0 million in new debt that will allow HP to purchase its leased facility outright, but will not expand capacity beyond 520. However, the proposed credit enhancement will result in rental cost savings and will enable HP to hire additional teachers and equipment to admit the 115 students on the waitlist.

The applicant notes expanding classroom space is contemplated as Phase II of the campus expansion program (Phase I being the purchase of the facility). Phase II would increase physical capacity by 7,500 square feet and enroll an additional 100 students at an estimated cost of \$1,050,000. HP estimates saving \$800,000 per year on rental costs. When required debt service is factored in, HP would save \$160,000 annually as a result of the credit enhancement program. The applicant notes the savings could be reinvested in the classroom or allow them to potentially complete Phase II within three years. The applicant notes it is their intention to expand capacity and that savings from the credit enhancement would allow them to expand sooner. However, the applicant disclosed that savings from credit enhancement may not cover the entire cost of adding additional classrooms and that additional borrowing or redirected cash may be needed.

Historically, only the Academy of Math and Sciences Application #1 (AMS) included proposed financing to purchase existing leased facilities. AMS requested \$1.1 million in guaranteed financing to purchase existing leased facilities at two campuses, constituting 3% of that applicant's total guaranteed financing request. The Board approved guaranteed financing of approximately \$670,000 to purchase an existing facility at one of the requested campuses. HP's request to purchase an existing leased facility represents 87.5% of the applicant's guaranteed financing request.

Eligibility for Credit Enhancement

A.R.S. §15-2155 requires that applicants provide proof as an Achievement District School, show sustainability of financial operations, provide information about the financing proposed to be guaranteed, and identify any property being pledged as collateral. Charter school applicants are additionally required to demonstrate experience in operating and managing charter schools and acknowledge that the financing will include a debt service reserve fund that is equal to at least the maximum amount permitted by federal law.

HP's proposed financing meets Board criteria for conditional approval for credit enhancement and compliance with the Terms and Conditions Agreement and Reimbursement Agreement will ensure that all program requirements are met. HP has not previously been assigned an underlying credit rating and submitted a letter denoting a financial hardship for obtaining a credit rating on existing facilities bonds.

Based on S&P's rating medians for charter schools for FY 2017, HP has high operating margins and cash reserves that are in line with BB rated charter schools, but is very small and will have high debt levels (nearly double that of other BB rated schools) after accounting for the proposed financing. Additionally, only one year of audited financial information is available as the school opened in FY 2018. The applicant provided financial statements for its associated charter, MHP, showing an increase in net assets and cash position in FY 2019 and FY 2018.

The applicant's underwriter believes HP would fall into the BB category given their significant waitlist size as a percentage of enrollment, student retention percentage, 110 days cash-on-hand, and lease-adjusted maximum annual debt coverage greater than the benchmark of 1.10x.

While Staff generally concurs with the applicant's underwriter that HP is not a credit risk to the program, the absence of an underlying credit rating would count against the 25% of guaranteed financings with an underlying credit rating of B+ or lower (*please see Impact on Credit Enhancement Program for more information*). HP would still experience significant cost savings from the enhancement even after accounting for the costs associated with obtaining an underlying credit rating. The Board might consider approving Option C as included in this memo, which would require the applicant to obtain an underlying credit rating of at least BB-. This option would maintain the Board's ability to approve guaranteed financing to future applicants without an underlying rating that may not demonstrate as strong of a performance against charter school medians or other signs of creditworthiness to the degree that HP does.

(Please see Appendix A for the Board's Financial Advisor's analysis of HP and program requirements.)

Impact on Credit Enhancement Program

The approval of any individual financing affects the Arizona Public School Credit Enhancement Program's capacity to enhance future financings, compliance with statutory ratios, and potentially the enhanced credit rating assigned to current and future financings.

If the proposed financing is approved as submitted, approximately 3.4% of the program's total capacity will be used to enhance this financing, bringing total program capacity to 47.2%.

A.R.S. §15-2155 requires that the Board ensure that the program leverage ratio, which is the ratio of the principal amount of guaranteed financings to the amount on deposit in the Arizona Public School Credit Enhancement Fund, not exceed 3.5 to 1. If the full amount of the proposed financing is approved for credit enhancement, the program will remain in compliance with the maximum program leverage ratio.

Most charter schools with underlying credit ratings are rated BB, BB+, BBB-, or BBB. However, if the applicant fails to obtain an underlying credit rating of BB- or higher, the financing would count against the maximum 25% of the aggregate principal amount of guaranteed financings, or \$87.5 million, that may have an underlying credit rating of B+ or lower. While the Board has only approved eight financings to five different borrowers, it is uncertain whether the applicant will have an underlying credit rating of BB- or higher. Vista College Prep was awarded \$10.5 million, or 7% of the program's total guaranteed financing, without an underlying credit rating and is counted against the 25% limit. Approving HP would bring this amount to 14% and could restrict space to approve future guaranteed financings to other applicant's without an underlying credit rating.

The higher the enhanced credit rating assigned to guaranteed financings, the greater the benefit of the program to participants. The assumptions made by rating agency Standard and Poor's in an initial review of the program included that the program would have approximately 35 participants with an average enhanced financing of \$10 million each. HP's proposed financing is near the average size of an enhanced financing assumed in this initial analysis.

Additional Considerations

Highland Prep has certified that no board members, employees, or immediate relatives of board members or employees will benefit from the proposed financing.

Appendix A

Date: 8-23-19

To: Sarah Giles

From: Michele Diamond, Financial Consultant

Subject: Evaluation of Highland Prep Application for the Public School Credit Enhancement Program-
Demonstration of Financial Sustainability

Conclusion: Highland Prep has sufficiently demonstrated financial sustainability as required by the Board's rules and based on the documents provided.

Review of Sarah's Memo

Eligibility for Credit Enhancement - Concur with the following exception:

"Additionally, only one year of audited financial information is available as the school opened in FY 2018."

The school subsequently submitted its FY 19 audit.

Notes to consider:

Note 1: **Informational Only** – Madison Highland Prep, an Associated Charter of the applicant, paid some operating expenses on behalf of the applicant in both fiscal year 2018 and 2019. This information does not change the consultant's conclusion related to financial sustainability.

Note 2: This memo should be reviewed in conjunction with the Evaluation Checklist

**Evaluation Checklist - Credit Enhancement Application
Highland Prep**

	FY 19	FY 18
Unqualified Opinion	√	√
Going Concern	√	√
45 Days Unrestricted Cash on Hand from most recent completed fiscal year	√	
OR		
30 Days Unrestricted Cash on Hand in most recently completed fiscal year	NA	
AND		
Net increase in cash from prior fiscal year	NA	
AND		
Unrestricted days cash on hand is projected to increase to 45 days within 2 years based on projections	NA	
Debt Service Coverage at 1.1 or higher	√	

** This document should be read in conjunction with the *Memo to Sarah*

Appendix A

**Days Cash On Hand
Highland Prep**

Source of Information

Cash	\$	591,376	Liquidity Statement and FY 19 Audit
Daily Expense	\$	5,463	
Days Cash On Hand		108	