Governor's Office of Strategic Planning and Budgeting
1700 West Washington, Suite 600, Phoenix, Arizona 85007
(602) 542-5381 • FAX: (602) 542-0868

Douglas A. Ducey
Governor

Matt Gress
Director

DATE: October 16, 2019

TO: Credit Enhancement Eligibility Board

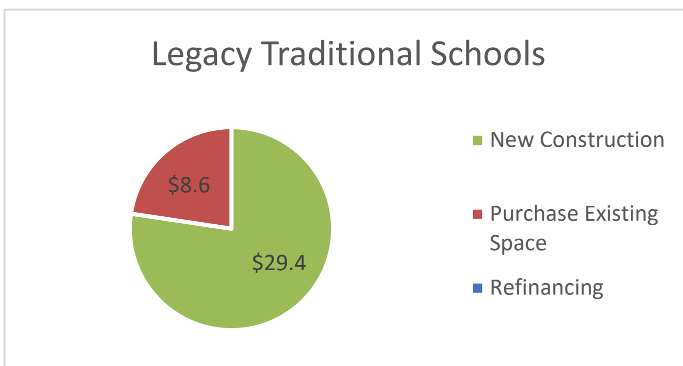
THRU: Matt Gress, Director, Governor's Office of Strategic Planning and Budgeting

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

SUBJECT: Legacy Traditional School – Application for the Public School Credit Enhancement Program

Summary of the Request

Legacy Traditional School (LTS) - Avondale has applied as an Achievement District School and for participation in the Public School Credit Enhancement Program for up to $38.0 million in proposed financing. LTS - Avondale requests enhancement for about $21.5 million to construct a new campus, $8.6 million to purchase an existing leased facility, and $7.9 million to expand an existing campus. The proposed financing will enable the LTS charter network to expand capacity by 1,600 seats and generate cost savings to be used for future expansion *(see Impact of Proposed Financing)*.



Based on staff review, LTS - Avondale meets the requirements to qualify for the Public School Credit Enhancement Program.

Recommendation

The Board has at least the following two options regarding LTS - Avondale'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, LTS - Avondale 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 $38.0 million.
B. Approval of credit enhancement for an amount that is less than the full amount of the proposed financing.
C. 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

The LTS charter network operates 15 schools in Arizona, each as a standalone charter with the Arizona State Board for Charter Schools (Charter Board), enrolling 17,501 students total in grades kindergarten through eight (K-8) in school year 2019-2020 with a waitlist of 1,198 students. LTS has three campuses in Nevada, but they are not included in the request for credit enhancement. Most campuses are in the Phoenix metropolitan area, but there are locations in Maricopa and Tucson. LTS also plans to construct an additional campus in Surprise and open for school year 2020-2021. The Charter Board approved the LTS - West Surprise charter in September 2019.

According to the application, LTS develops a solid foundation of fundamental and higher-level thinking skills through structured curriculum that is consistent within each grade level and sequential throughout grades with a rigorous focus on reading, writing, mathematics, social studies and science. The applicant reports that students' average passing scores on the 2019 AzMERIT test were 61% for English Language Arts (ELA) and 66% for Math compared to the statewide average of 43% for ELA and 45% for Math for grades K-8.

Additionally, the applicant reports between 16% and 48% of students qualified for free or reduced-price during school year 2018-2019, compared to 53% of elementary students in the Dysart Unified School District in Surprise, 80% of students in Phoenix Elementary District, and in 31% of students in Litchfield Elementary District in Goodyear .

School	Original Obligated Group Member[1]	Proposed Obligated Group Member[2]	2017-2018 Letter Grade	2019-2020 Enrollment	2019-2020 Waitlist	FRL %	Amount Requested for Credit Enhancement
LTS-Avondale	Yes	Yes	A	1,336	432	32%	
LTS-Casa Grande	Yes	Yes	A	1,220	41	40%	
LTS-Chandler	Yes	Yes	A	1,243	16	12%	

[1] FY 2017 and FY 2018 audited financial statements in the application materials are for the original obligated group, not included in this list is the LTS – North Valley campus in Nevada

[2] Projected financial information is based on the proposed obligated group which contains all LTS schools in both Nevada and Arizona (adds six schools to the obligated group)

LTS-East Mesa	*No*	Yes	N/A[3]	878	16	50%	
LTS-Gilbert	Yes	Yes	A	1,161	12	16%	
LTS-Glendale	Yes	Yes	A	1,203	8	24%	
LTS-Goodyear	*No*	Yes	N/A[4]	444	41	42%	$8.6 million
LTS-Laveen	Yes	Yes	B	1,115	97	26%	
LTS-Maricopa	Yes	Yes	A	1,301	23	32%	
LTS-North Chandler	Yes	Yes	A	957	32	48%	
LTS-Northwest Tucson	Yes	Yes	A	1,200	0	23%	
LTS-Peoria	Yes	Yes	A	748	2	21%	
LTS-Phoenix	*No*	Yes	N/A[5]	1,430	265	48%	$7.9 million
LTS-Queen Creek	Yes	Yes	A	1,353	91	22%	
LTS-Surprise	Yes	Yes	A	1,912	222	20%	
LTS-West Surprise	*No*	Yes	N/A[6]	N/A	N/A	N/A	$21.5 million
Total				**17,501**	**1,298**		**$38.0 million**

Application Details:

Date Received: 9/4/2019
Date Complete: 9/26/2019
Deadline to Approve/Deny: 11/25/2019

Applicant Contact: Corey Kennedy, Chief Financial Officer, Vertex Education
Borrower's Counsel: Warren Charter Law, PLC
Bond Counsel: Engelman Berger, P.C.
Underwriter: RBC Capital Markets
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 LTS - Avondale in its application, Staff believes LTS - Avondale has met the criteria established in statute.

[3] School year 2017-2018 was the first year of operation and schools do not receive a letter grade in their first year
[4] School year 2017-2018 was the first year of operation and schools do not receive a letter grade in their first year
[5] School year 2019-2020 is the first year of operation and schools do not receive a letter grade in their first year
[6] School will not open until school year 2020-2021

Requirement	Status
Assigned a letter grade of A, or an equivalent successor classification	Verified for 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 1,298 students on waitlist across LTS network
Sound financial plan that contemplates operational costs and future enrollment growth	Financial Documents
Commitment to provide technical assistance to an underperforming school	Partnership with Arizona Autism Charter School

At the time of application, the LTS network reported a wait list of 1,298 potential students based on expressed intent to enroll, including 41 students at the LTS - Goodyear campus where enhancement for $8.6 million was requested to purchase the existing, leased facility. Additional, LTS requested to build a new LTS - West Surprise campus that the applicant believes will reduce the waitlist of 222 students at the nearby LTS - Surprise campus. Enhancement was also requested to expand the LTS – Phoenix campus to accommodate the waitlist of 265 students.

LTS has partnered with Arizona Autism Charter Schools, Upper School Campus, a “D” rated charter school in Phoenix, to provide technical assistance on business services, including sustainable growth, and professional development for Arizona Autism Charter Schools staff.

Impact of the Proposed Financing

LTS requested enhancement for four projects, totaling $38.0 million in proposed financing, which include:

1) $21.5 million to construct a new campus, LTS - West Surprise, and create an additional 1,350 seats to alleviate the waitlist of 200 students at the LTS - Surprise campus. The applicant notes increased development resulting in growing enrollment demand in this area. The new, 81,725-square-foot K-8 campus will include 47 classrooms and extracurricular space such as a piano lab, a stage, and athletic fields.

2) $8.6 million to purchase the existing, leased LTS - Goodyear campus which was acquired when another charter abruptly closed in 2018. The applicant notes this “expands” capacity by 750 seats by ensuring continued operation of the Goodyear campus, but this project does not result in expanded building capacity. Given continued growth surrounding Goodyear, the applicant notes the LTS- Goodyear campus has potential for expansion as early as school year 2021-2022.

3) $7.9 million to expand LTS - Phoenix and create an additional 630 seats and alleviate the waitlist of 265 students. The new space would expand LTS – Phoenix by 39,725 square-feet and include 30 classrooms and extracurricular space such as a piano lab and athletic fields.

The applicant also applied for enhancement to refinance a short-term financing instrument used to construct the LTS-Phoenix campus with long-term, credit enhanced bonds at a cost of $26.3 million. The applicant requested to remove this project from consideration. The applicant estimates that savings from credit enhancement will total $7,440,000 over the lifetime of the bonds and plans to use those savings to increase cash reserves, support repairs and maintenance at campus facilities, and provide competitive salaries and benefits to staff across the LTS system.

If the Board prefers to lower the amount of the enhancement to be more in line with the average approved enhancement amount of $20.8 million since program inception, or closer to S&P's initial assumptions of the average enhancement amount of $10 million, then Staff would recommend considering approval of enhancement for projects at existing schools (LTS-Goodyear and LTS-Phoenix) or approval for only construction of the new campus in West Surprise. Such an approach would lower the enhancement amount from $38.0 million to $16.5 million (existing schools) or $21.5 million (new campus).

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.

LTS' 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.

LTS has seven outstanding bonds, though only the Series 2013, Series 2015, and Series 2016 bonds are rated. S&P assessed the Series 2013 and Series 2015 bonds as a BB. Moody's assessed the Series 2016 bonds as a Ba1 which is equivalent to a BB+ rating. Moody's formally renewed the Series 2016 rating of Ba1 in September 2019, but in October 2019 Moody's changed the rating for LTS to Ba2 which is equivalent to a BB rating. Existing bond covenants require LTS to maintain at least the Ba2 underlying rating to issue additional bonds. Based on S&P's rating medians for charter schools for FY 2018, LTS has a waitlist as a percentage of enrollment that is in line with BB+ rated schools and days cash on hand in line with BB rated schools. However, the LTS's debt per student is higher than S&P's FY 2018 charter school medians for highly rated charter schools. LTS's debt service coverage ratio is above the 1.10 benchmark.

S&P FY 2018 Charter Sector Medians – Debt per Student							
BBB+/BBB	**BBB-**	**BB+**	**BB**	**BB-**	**B+/B/B-**	**LTS - Current**	**LTS – With Enhancement**
$11,842	$13,975	$15,524	$16,811	$13,400	$15,474	$19,595	$19,554

LTS is requesting enhancement as an obligated group comprised of all LTS campuses. The obligated group structure allows campuses to support each other financially in order to continue to service the bonds payable and meet all bond covenants as needed. Of the prior credit enhancements approved by the Board, one applicant was structured as an obligated group.

LTS Chandler, Gilbert, Glendale, Laveen, North Chandler, and Peoria were identified on the Charter Board's financial performance framework for reporting negative net income in recent fiscal years. LTS North Chandler and Peoria were also identified as a going concern in FY 2017 and FY 2018 and have had to borrow from other schools in the obligated group due to lower enrollment than forecasted. Because these schools are part of a larger obligated group structure, and, according to the applicant, is currently enrolled at 95% of the system's capacity, Staff does not believe the applicant is a credit risk. Further, the system demonstrates solid academic performance throughout with only one school receiving a B rating which services approximately 6% of the system's total student population.

(Please see Appendix A for the Board's Financial Advisor's analysis of LTS 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 10.8% of the program's total capacity will be used to enhance this financing, bringing program usage to 62.0% of the total capacity.

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. LTS would not count against the 25% trigger since its latest underlying rating is BB.

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. LTS' proposed financing is larger than the average size of an enhanced financing assumed in this initial analysis.

Additional Considerations

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

LTS settled two lawsuits related to construction workmanship within the past three years.

Disclosure: The Credit Enhancement Eligibility Board (CEB)'s Financial Advisor, Diamond Financial Solutions, notified CEB staff that the applicant's underperforming school partner, Arizona Autism Charter Schools, is a client of the Financial Advisor. CEB staff independently reviewed LTS application materials to determine compliance with program requirements, and came to the same conclusions at the Board's Financial Advisor.

Date: 10-15-19

To: Sarah Giles

From: Michele Diamond, Diamond Financial Solutions - Financial Advisor

Subject: Evaluation of Legacy Traditional Schools for the Public-School Credit Enhancement Program - Financial Sustainability

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Conclusion: Legacy Traditional Schools (LTS) has sufficiently demonstrated financial sustainability based on the Board's requirements as outlined in rule and per the documents provided.

Notes to consider:

1. Audited financial statements provided are based on an **existing** Obligated Group that will be materially different than the **proposed** Obligated Group and for which the projected years of fiscal year 2020 and 2021 are based. The proposed Obligated Group will include 6 additional schools: two schools operating in Nevada, 3 Arizona schools with less than two years operating history and one Arizona school that has not yet opened. This note is informational only and does not change the conclusion above.

2. Debt service coverage ratio and days cash on hand for most recently completed fiscal year are based on FY 19 internal [unaudited] financial statements of the proposed Obligated Group (with the exception of West Surprise which is not included as it has not yet opened). This note is informational only and does not change the conclusion above.

3. FY 18 financial statements, the most recently audited fiscal year (of the existing Obligated Group) indicates a net loss in both accrual and cash terms. This note is informational only and does not change the conclusion above.

4. The applicant provided financial information [unaudited] showing improved trending for all schools that previously did not meet the Charter Board's financial performance framework.

5. Unrestricted days cash on hand (UDCOH) appears to include classroom site fund carryover (restricted). Revised UDCOH still meets the 45-day requirement. This note is informational only and does not change the conclusion above.

6. Arizona Autism Charter Schools, the underperforming school that LTS will partner with is currently a client of Diamond Financial Solutions

7. This memo should be reviewed in conjunction with the Evaluation Checklist

Evaluation Checklist - Credit Enhancement Application
Legacy Traditional Schools

	Projected Years	Most Recently Completed Fiscal Year (FY 19)	FY 18 Audited	FY 17 Audited
Unqualified Opinion	n/a	n/a	√	√
No Going Concern	n/a	n/a	√	√
45 Days Unrestricted Cash on Hand from **most recently completed fiscal year** and all projected years	√	√	n/a	n/a
OR				
30 Days Unrestricted Cash on Hand in **most recently completed fiscal year**	N/A	N/A	N/A	N/A
AND				
Net increase in cash from prior fiscal year	N/A	N/A	N/A	N/A
AND				
Unrestricted days cash on hand is projected to increase to 45 days within 2 years based on projections	N/A	N/A	N/A	N/A
Debt Service Coverage at 1.1 or higher for most recently completed fiscal year	n/a	√	n/a	n/a

Evaluation Checklist - Credit Enhancement Application

Legacy Traditional Schools

	FY 2019 Estimated**	**FY 18 Audited**	**Notes**
Net Income	1,957,862	-1,704,851	
Add Back:			
Depreciation	9,564,745	7,461,482	
Interest on Existing/New Bonds	16,502,032	13,394,433	
Interest-amortization of deferred bond issuance costs, discounts and premiums	742,996	190,591	
Bond Fees			Info not available
Net Income Available for Debt Service	28,767,635	19,341,655	
Bond principal payments	Pending	2,455,000	
Bond interest payments	13,293,712	13,394,433	
Total annual debt service	13,293,712	15,849,433	
Debt service coverage ratio with CEP		1.22	

** Cannot confirm calculation. Applicant provided updated documents on 10-16-19 that suggest the FY 19 income statement originally p

Days Cash On Hand							
Legacy Traditional Schools							
	FY 23	FY 22	FY 21	FY 20	FY 19**	FY 18	Notes
Cash	51,923,562.00	47,929,241.00	40,575,290.00	32,576,436.00		$ 19,181,746	
Total Expenses	206,704,424.00	202,185,646.00	195,181,927.00	178,578,822.00	148,611,287.00	110,591,692	
Add Back:							
Depreciation	12,751,238.00	12,229,159.00	11,798,018.00	11,259,194.00	9,564,745.00	7,461,482	
Amortization	1,085,721.00	1,095,152.00	1,103,747.00	742,565.00	742,996.00	190,591	
Total Adjusted Expenses	192,867,465.00	188,861,335.00	182,280,162.00	166,577,063.00	138,303,546.00	102,939,619	
Daily Expense	528,404.01	517,428.32	499,397.70	456,375.52	378,913.82	$ 302,991	
Days Cash On Hand	98	93	81	71		63	DCOH results vary from applicant's but still meets the requirement of 45 unrestricted days DCOH

** Cannot confirm calculation. Applicant provided updated documents on 10-16-19 that suggest the FY 19 income statement originally provided (and for which the numbers in column F are based) are no longer accurate. No accompanying financial statements were provided.