M E M O R A N D U M **Staff Summary No. 5**

Date: July 11, 2018

To: Members of the California School Finance Authority

From: Katrina M. Johantgen, Executive Director

Subject: Resolution 18-11 – Approval of the Revolving Loan Fund Program Recommendations and Amounts (Action Item)

Overview: In December 2017, the California School Finance Authority (Authority) opened the Revolving Loan Fund Program (Program) application period for the 2017-18 funding round. By the February 28, 2018 deadline, 65 timely applications were received, totaling funding requests of $16.25 million. Approximately $10 million is available for funding this year, assuming a transfer from the Program Security Fund is effectuated by August 2018. Since February, Authority Staff have been assessing eligible loan applications, following the framework established by statute and regulation, and following the review process described below.

Staff reviewed two tiers of applications: (1) 51 schools opening in 2018-19, that are considered priority one applications; and (2) 14 schools that have already opened and are classified as priority two applications. Since applying in February, several applicants have withdrawn their applications, primarily due to delays in receiving charter approval or securing facilities.

At this time, Staff is recommending loans for board approval, for priority one schools listed in Exhibit A of Resolution 18-11 at our July 11, 2018 meeting. Staff is still reviewing the remaining priority one applications and all priority two applications and anticipates bringing the balance of its loan recommendations to the Authority's August meeting.

Staff Review Process: Since the Authority began administering the Program in 2013-14, Staff and our advisors have worked, through regulation, policy and underwriting criteria, to mitigate Program defaults and maintain the balance of the fund to ensure future loan awards. While understanding some defaults are unavoidable due to the nature of the program[1], the Authority continues to develop methods and practices that further mitigate losses.

Based on an analysis of defaulted loans, Staff has determined that the primary reason for Program loan defaults is that actual enrollment figures are coming in well below the borrowers' assumptions at initial review when loan awards are made. With roughly 95% of a new charter school's revenue dependent on reported average daily attendance, the accuracy of projected attendance has a greater impact on financial performance than the

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[1] Section 41365(e) of the Education Code: states "Priority for loans from the Charter School Revolving Loan Fund shall be given to new charter schools for startup costs."

school's management of expenses. With this in mind, Staff and our financial advisor refined the financial model used to evaluate loan applications by focusing on the relationship between projected attendance and the school's ability to repay the loan.

For the 2017-18 funding round, the Authority refined its financial model, required more stringent confirmation regarding enrollment totals using tools such as the state's PENSEC[2] form, and developed a disbursement timeline in which applicants are disbursed loan proceeds only when enrollment and financial projections are met. *Staff will continue to monitor the efficacy our underwriting due diligence and also will be proposing legislative changes to ensure the long-term viability of the program.*

Below is an outline of our application review and loan underwriting and funding process.

1. **Application Eligibility & Package Review:** Confirmed that the submittal complied with application terms such as:
   - Met application deadline;
   - Met eligibility requirements set forth in regulations (Section 10170.18);
   - Submitted required documentation with signatures, where applicable;
   - Requested a loan amount that is equal to or less than $250,000; and
   - Requested a loan repayment period of 5 years or less.

2. **Operational Analysis**: Determined whether minimum qualifications were met such as:
   - Articles of Incorporation are in place;
   - Approved charter is in place or is in process;
   - Detailed business and marketing plan completed;
   - Board of Director listing submitted with no apparent conflicts;
   - Key staff resumes demonstrate relevant education and experience;
   - Projected enrollment and Average Daily Attendance (ADA) are supported by student enrollment and/or waiting lists;
   - Student population seems representative of the demographic in the school's proposed location; and
   - A facility has been secured or is in the process of being secured.

3. **Financial Analysis:** Conducted fiscal evaluation based on a variety of indicators and critically analyzed financial data and ratios against benchmarks and industry practice using an internally created financial model to identify fiscal strengths and weaknesses such as:
   - Availability of other sources of funding;

[2] Pupil Estimates for New or Significantly Expanding Charters (PENSEC) includes estimated average daily attendance (ADA) and other pupil counts for charter schools that will be newly operational or for charter schools that will be significantly expanding in fiscal year (FY) 2018-19.

- Reasonableness of budget assumptions (Staff applied uniform LCFF funding rates to all applicants);
- Alignment of revenue and expenditure projections with comparable data available from the California Department of Education;
- Consideration of sale of apportionments to third parties (“factoring”); and
- Adequacy of debt service coverage metrics relative to threshold levels, with and without net assets.

Staff’s financial analysis utilizes three debt service coverage (DSC) metrics: (1) DSC from total state aid subject to CSFA intercept; (2) DSC from net revenues; and (3) DSC from net revenues plus beginning net assets. Threshold levels are set for each of these three metrics. If the applicant attains these threshold levels during the years of loan repayment, then up to 70 total points are received. The applicant can receive up to an additional 30 points, for a maximum score of 100 points, if the DSC threshold levels are attained under a scenario wherein projected attendance levels are reduced by 33.3% (the stress test). Applicants who meet or exceed the 50-point threshold would qualify as passing in the context of the Program’s loan underwriting standards. Staff also reduced loan amounts for applicants that don’t otherwise meet the threshold underwriting standards, with a minimum $100,000 loan.

The financial model also determines the risk profile of an applicant with a passing score. Applicants with scores ranging from 50.0 to 69.9 are viewed as “higher risk”, while applicants with scores ranging from 70.0 to 89.9 are deemed “medium risk”, and applicants with scores ranging from 90.0 to 100.0 are considered “lower risk”. Schools assessed as medium risk and lower risk have attained DSC threshold levels in some or all years under the stress test scenario. Additionally, any application which includes a loan guarantee from an affiliated organization deemed credible by Staff has their risk profile improved by one level, such as from “higher risk” to “medium risk” or from “medium risk” to “lower risk”.

4. **Loan Recommendations:** Staff considered all operational and financial information and assumptions for each loan and performed the following:
   - Assigned risk profiles—lower, medium, or higher;
   - Sorted applicants by priority and, as the Program is oversubscribed, sorted by highest free or reduced-price meal percentage across regions in accordance with California Code of Regulations §10170.17(o) through (r) and §10170.20(c) through (e); and
   - Based on the availability of funds, recommended specific loans for approval or non-approval.

5. **Amount and Term:** Furthermore, Staff used Section 10170.21(b)(1) of the Program regulations to identify the recommended loan amount and repayment period of each recommended loan. The regulations state that the Authority shall consider the term of the charter as well as the loan amount in determining the repayment period.

To further mitigate default risk, Staff based the recommended loan amount and repayment period on the school's charter term. Staff recommended that each applicant have a repayment period that does not exceed the school's charter term and a loan amount that the school is projected to be able to repay within the loan term without compromising operations, based on the results of the financial analysis described above.

6. **Disbursements:** In an effort to reduce losses to the Program, Staff proposes to reduce loan defaults by (1) increasing the frequency of attendance monitoring in the year of loan award, and (2) limiting loan disbursements to borrowers with attendance certified at levels consistent with previously submitted projections and adequate to repay the loan. For any loan amount approved by the board for lower risk applicants, the first of two potential loan disbursements would occur the month after approval up to a maximum amount of 40% of loan amount. A subsequent disbursement of the remaining 60% will occur once CDE certifies the applicant's attendance, typically in mid to late September. For any loan amount approved by the board for medium or higher risk applicants, the first of four potential loan disbursements would occur the month after approval up to a maximum amount of 40% of loan amount. The three subsequent disbursements would be up to 20% of the remaining amount. Each disbursement will occur in the months after CDE certifies attendance in late September, late December, and mid-February. Borrowers reporting attendance at levels which are not adequate to repay the loan will have future disbursements downsized or eliminated.

For your review and consideration, Staff provides summary findings for each recommended school in the attached Exhibit A – RLF Board Matrix. In order to receive funding through the Program, schools must meet the following funding criteria, once approved by the Authority board:

- Continue to meet all eligibility criteria;
- Have an approved charter in place;
- Have a Charter Number from CDE;
- Have been assigned a County-District-School Code from CDE;
- Have submitted attendance reports that reflect enrollment numbers similar to those projected by schools and stress tested by Authority Staff at the time of initial review; and
- Provide an executed loan agreement and related governing board resolution to the Authority.

Recommendation: Staff recommends that the Board adopt Resolution No. 18-11, approving revolving loan fund recommendations and amounts to the schools listed in the attached Exhibit A – RLF Board Matrix. Once approved, Staff will notify schools of conditional loan approval, confirm schools meet all funding criteria before releasing funds, distribute and execute loan agreements, and carry out all other necessary steps to disburse funds to schools.