M E M O R A N D U M **Staff Summary Item No. 7**

Date: August 28, 2019

To: Members of the California School Finance Authority

From: Thomas Dear, Staff Services Manager II

Subject: Resolution 19-26 – Approval of the Revolving Loan Fund Program Recommendations and Amounts (Action Item)

Overview: In December 2018, the California School Finance Authority (Authority) opened the Revolving Loan Fund Program (Program) application period for the 2018-19 funding round. The Authority received 30 timely applications by the February 22, 2019 deadline, with a funding requests totaling $7.35 million (M) and approximately $8 M is available for funding this year. Since February, Authority Staff have assessed eligible loan applications, following the framework established by statute and regulation, and adhere to the review process described below.

Staff reviewed two tiers of applications: (1) 23 schools opening in 2018-19, considered priority one applications; and (2) seven schools that have already opened and are classified as priority two applications. Since applying in February, several applicants have withdrawn their applications, primarily to delays in receiving charter approval or securing facilities, while one applicant was found ineligible for the Program. At its June 12, 2019 board meeting, the Authority Board approved 19 priority one schools for loans totaling $4.65 million. Staff has diligently worked to process loan agreements and initial disbursements for many of these schools and continues to do so.

At its August 28, 2019 Board Meeting, staff is recommending six priority two loans for approval, listed in Exhibit A of Resolution 19-26. This will bring a close to the 2018-19 funding round of the Charter School Revolving Loan Fund Program.

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 to further mitigate losses.

Based on an analysis of defaulted loans, Staff determined that the primary reason for Program defaults are actual enrollment figures are below the borrowers' assumptions. With roughly 95% of a new charter school's revenue dependent on reported Average Daily Attendance (ADA), the accuracy of projected attendance has a greater impact on financial performance than the school's management of expenses. With this in mind, Staff and our

[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."

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.

In last year's 2017-18 funding round, the Authority required more stringent enrollment confirmation from the California Department of Education (CDE) to ensure that financial projections were being met. After one year of administering this new process, this change in the Program saved approximately $150k from a school that was not meeting attendance requirements and based on its performance its charter was revoked. This school closed midway through the school year with only the initial $100k disbursed rather than the entire approved loan amount of $250k. *Staff will continue to monitor the effectiveness of our underwriting due diligence.*

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

1. **Application Eligibility & Package Review:** Confirmed the submittal complied with application terms such as:
   - Met application deadline;
   - Eligibility requirements set forth in regulations (Section 10170.18);
   - Submitted required documentation with signatures, where applicable;
   - Requested a loan amount equal to or less than $250,000; and
   - Requested a loan repayment period of five 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 ADA are supported by student enrollment and/or waiting lists;
   - Student population was deem 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;
   - 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 CDE;
- Consideration of sale of apportionments to third parties ("factoring"); and
- Adequacy of debt service coverage (DSC) metrics relative to threshold levels, with and without net assets.

Staff's financial analysis utilizes three 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 a maximum 70 points are recorded. The applicant may 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 25% (the stress test). Applicants that meet or exceed the 50-point threshold qualify as passing in the context of the Program's loan underwriting standards. Staff also reduced loan amounts for applicants that do not otherwise meet the threshold underwriting DSC 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 75.0 are viewed as "higher risk", while applicants with scores ranging from 74.9 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 its risk profile improved by one level, such as from "higher risk" to "medium risk".

4. **Loan Recommendations:** Staff considered all operational and financial information and assumptions for each loan and performed the following:
   - Assigned risk profiles—low, medium, or high;
   - Sorted applicants by priority 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 loan. The regulations states 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 each applicant have a repayment period that does not exceed the school's charter term. Additionally, staff recommended each applicant be awarded a loan that can be repaid within the loan term based on the results of the financial analysis described above.

6. **Disbursements:** In an effort to reduce losses to the Program, Staff will continue 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. For any loan amount approved by the Board for lower risk applicants, the first of two potential loan disbursements would occur after loan documents are executed, 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 December. For any loan amount approved by the board for medium or higher risk applicants, the first of three potential loan disbursements would occur after loan documents are executed, up to a maximum amount of 40% of loan amount. The two subsequent disbursements would be up to 30% of the remaining amount. Each disbursement will occur in the months after CDE certifies attendance in 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 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; and
- Provide an executed loan agreement and related governing board resolution to the Authority.

Recommendation: Staff recommends the Board adopt Resolution No. 19-26, approving Revolving Loan Fund Program recommendations and amounts to the schools listed in the attached Exhibit A – RLF Board Matrix. Once approved, Staff will notify schools of the conditional loan approvals, 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.