

**Debunking the Real Estate Risk
of Charter Schools**

A Study by the
Ewing Marion Kauffman Foundation

KAUFFMAN
Foundation

EXECUTIVE SUMMARY

This study from the Ewing Marion Kauffman Foundation reveals that landlords and real estate lenders who are wary of dealing with charter schools may perceive the schools as much riskier clients than they actually are.

This report comes at a time when real estate issues are taking center stage in the growing charter movement. For many charter schools—independent public schools started by local citizens—simply securing an adequate building for the long term can be a major hurdle. Although charters represent a growth market for lenders, developers, and the like, affordable deals are often hard to come by—in part because this is a fairly new and unusual kind of market, and the risks of a school failing or defaulting are not well understood.

In research meant to clarify the picture, the Kauffman Foundation arrived at several key findings:

- Existing data on charter school closings are generally accurate, but can be misleading to lenders and investors because the figures don't take into account real estate issues. For instance, one commonly cited survey appears to show that nearly one in ten charter schools have "closed." But the schools thus counted include many that just changed organizational structure, and continued to occupy and pay on their buildings. The Kauffman Foundation calculates that in fact, fewer than 6 percent have failed to do so.
- Even when buildings are prematurely vacated, the vast majority are able to be leased or sold to others on terms no less favorable to the lender or landlord. (Another common concern is that facilities fitted out as schools may not be easy to re-market. But the current rate of re-use on equivalent terms is more than 95 percent.)
- Certain factors, when present, can greatly reduce overall risk. Charter schools started in conjunction with Education Management Organizations (EMOs) were found to have almost negligible failure rates, even if the contract with the EMO is later terminated. Also, charter schools with more students are less risky than average, as are those started one year or more after the home state passes a charter law.
- Finally, and ironically, the inability to find adequate buildings is itself a key contributor to charter school failures. Thus the whole dilemma is to some extent circular: securing a long-term lease or mortgage helps a charter school to stabilize, attract students and survive—but many cannot strike such a deal because of concerns that they won't survive.

INTRODUCTION

About Charter Schools and Real Estate Issues

Since the first state charter laws were passed in Minnesota in 1991, some 3,400 charter schools have been launched in various states across the United States. About that many more are expected to open over the next five to six years. Typically they are started by local parents, teachers, and/or civic leaders seeking different approaches, and thus more choices, in education. For instance charter schools may differ from other nearby schools by having longer or non-standard school days, by adopting special teaching methods, or by being “themed” to emphasize certain subjects or modes of learning.

Charter schools are independent, with their own boards of directors and budgets, but they are public schools. They receive per-pupil operating funds from the districts and states in which they are located (though typically at less than 100 percent of the equivalent cost of educating students in other public schools). In addition, charters are often treated as “Local Educational Agencies,” or their own school districts, but lack the tax base and bonding authority of traditional district authorities.

In return for their freedom and funding they usually must take all neighboring students who apply (with an impartial selection device, such as a lottery, used if there are more applicants than openings), and they must meet agreed-upon performance measures: each state has its own guidelines in all these matters.

Facilities can be a problem for several reasons. Rarely is a vacant school building available in good condition and in a suitable location. Often a space must be adapted or upgraded, which adds to the expense. Some charter schools have benefactors to help pay for a facility or even donate one, but most, especially in lower-income areas, do not. Many schools cope by growing in stages—starting out with grades K–2, for example, and planning to expand year-by-year to K–5 or K–8. Among other benefits, this can minimize capital costs at startup by requiring only a small space initially. The idea is to move to larger quarters as funding grows along with the student population. Since moving repeatedly is distracting and costly in its own right, the school should settle into a long-term lease or mortgage on a full-sized facility as soon as possible. But that step often proves to be the most elusive.

Low-cost, charity-rate loans and mortgages for large amounts are scarce. And on the conventional market, charter schools tend to encounter additional charges rather than discounts. Lenders and landlords, in dealing with an unfamiliar type of applicant, may naturally try to cover the perceived risk by asking for extra loan

guarantees, security deposits, and/or premium rates—which the schools, in many cases, cannot afford.

Some nonprofits and public agencies have started loan-guarantee funds to help charter schools meet lenders' requirements (one such public program, sponsored by the Department of Education, we review on page 8). Such efforts can be useful, but in studying them, the Kauffman Foundation noticed something else that leapt out. The “perceived risk” levels appeared to be unusually high (perhaps because of the relative funding disadvantages charters confront and that were described earlier). As a result, some lenders and landlords could be missing out on deals that could have been made, by trying to cover more risk than they actually faced. And perhaps many well-conceived charter schools were missing out on buildings they could have paid for, if the bar were not set too high. Further study has indicated that this may indeed be the case.

KAUFFMAN FINDINGS ON REAL ESTATE RISK

The Kauffman Foundation's data analysis on this topic was directed by Robert Litan, vice president of research and policy, and conducted by research and policy associate Leslie Lukens. The work carried out over several months in early 2005. The Kauffman Foundation team was greatly assisted by the Center for Education Reform (CER), which provided data and technical advice for this study.

Here are our findings on several key issues.

Existing studies were not meant to look at charter schools from a real estate perspective, and can be misread to overstate the risk.

Perhaps the most widely used source of statistics is the 2004 edition (published in May) of the report "Charter Schools Today: Changing the Face of American Education; Statistics, Stories, and Insights," from the Center for Education Reform, which tracks virtually all charter school closings in the United States through the 2002–2003 school year. The CER report indicates that 9.41 percent of all charter schools have "closed"—but the figure should *not* be used for gauging real estate risk. It needs to be adjusted downward for that purpose; the Kauffman Foundation suggests that a more accurate figure would be slightly less than 6 percent.

First, it is important to note that the percentage in the CER report is not an annual rate. If more than 9 percent (or even 6 percent) of charter schools closed every year, they would be risky ventures indeed, but that is not the case. Percentages measured by CER (and by the Kauffman Foundation) are cumulative counts. They represent how many charter schools have closed *thus far* out of all such schools that have *ever* existed in the United States since 1991.

Second, the CER definition of a "closed" or "failed" charter school is very broad. The schools counted as such may no longer be operating in their original form—that is, as independently run charter schools—but not all of them actually closed down, nor by any means did all of them default on building leases or mortgages. Researchers at the Kauffman Foundation examined the underlying data and re-ran the calculations, excluding all events that did not involve real estate risk. Excluded, for instance, were:

- Charter schools that were absorbed into their local school districts, but continued to occupy and use their buildings. (A school of this kind essentially becomes a "regular" public school—the district operates it, and takes financial responsibility for it.)

- Charter schools that merged with other institutions, but again continued to occupy and use their buildings for educational purposes.
- Charter schools that closed *because* they were unable to obtain an adequate facility. These were cases that obviously did not pose any risk to a lender or landlord. They included schools failing to get even an initial lease or mortgage, as well as schools forced out of their existing facilities and unable to secure new ones. (For example: the landlord terminated or did not renew a short-term lease, or safety inspectors closed the facility, or the school had outgrown its space and disbanded after not finding larger quarters in time.)

Adjusting the CER data to remove cases like those listed here, the Kauffman Foundation found the cumulative *real estate risk* to be not 9.41 percent, but rather 5.95 percent. That is:

Using data from the latest CER report, Kauffman finds that of all charter schools that have ever opened in this country, 5.95 percent have closed in a way that impacted their landlords or real estate financiers.

Even when charter schools actually fail, the re-use rate of facilities is very high.

With CER data plus follow-up telephone surveys, the Kauffman Foundation was able to determine what happened to the facilities of 106 charter schools that had actually closed and vacated their premises, which represents approximately one-third of all closed charter schools. The great majority of buildings and spaces—95.8 percent—were in use by new occupants. State education officials reported that landlords faced no loss in nearly all of these cases and were able to re-lease the facilities at equal or higher rates to the new tenants. So few facilities remained empty at the time of the survey that it was not possible to make a meaningful study of the losses, if any, incurred in those situations: the sample was too small.

This finding suggests that one of the chief “downside” risks feared by many landlords and lenders—inability to re-market the space easily, in case a charter school defaults—should in fact not be a major concern.

Having a long-term facility solution reduces the risk of charter school failure.

As already shown, some charters fail, ironically, precisely because they cannot lease or buy adequate facilities. Of the 317 charter schools listed as “closed” in the latest CER report, 33—more than 10 percent—reported closing for lack of a suitable property.

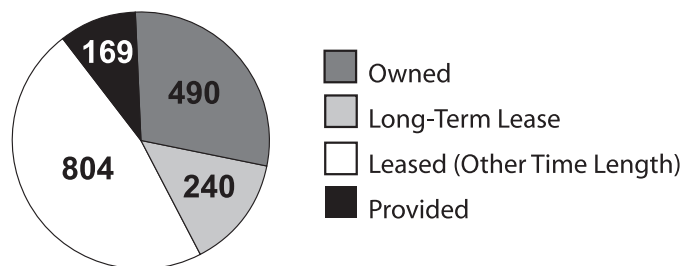
Owning a building is the best long-term solution. In follow-up studies, the Kauffman Foundation was able to get detailed reports on facility status for over 1,800 charter

schools, more than half of the nearly 3,400 that have ever opened in the United States.

- Of the 109 schools in the Kauffman Foundation sample that had *closed*, only five (4.58 percent) actually owned or had a mortgage on their building at the time of closing.
- By contrast, of the 1,703 schools in the sample that were still open, 490—28.77 percent—owned or had mortgages on their buildings.

For practical purposes a long-term lease—of ten years or more—is nearly equivalent to ownership. Altogether (see Figure 1 below), 42.8 percent of the currently-open charter schools in the Kauffman Foundation sample either owned or had long-term leases on their facilities. That is the good news.

Figure 1. **Status of Building of Open Charter Schools**



The ominous news is that 47.2 percent of the charter schools in the Kauffman Foundation survey sample—804 of 1,703—had only short-term leases. These schools may have adequate spaces at present but do not have homes assured for the future—they are the schools living on the cusp, the ones that will need to find such homes before long.

The remaining 9.9 percent of the schools in the Kauffman Foundation sample, 169 of 1,703, had facilities “provided” for them—for instance by private benefactors, by nonprofit partners, or (in some cases) by local school districts. The arrangements vary. Some of these schools can count on long-term homes, but others are being housed on an ad hoc basis. Like the charter schools with short-term leases, they too may soon be in the hunt for other and more permanent facilities.

These data strongly suggest, therefore, that lenders and landlords approached by charter schools should certainly weigh all risks—but weigh them accurately, and keep in mind that *the willingness to provide a long-term facility on affordable terms* is, itself, a key risk-reduction factor.

Other risk-reduction factors are summarized on following pages.

The presence of an EMO at startup dramatically reduces the risk of charter school failure.

EMOs are entities that will manage a school, on a contract basis, for the directors of that school. Typically they offer a pre-developed pedagogic model plus administrative experience. EMOs exist in both for-profit and not-for-profit forms, and most provide turnkey contracting—that is, they can handle all aspects of starting and running a school—though some may be engaged for only parts of the task.

The Kauffman Foundation studied 413 charter schools started in conjunction with for-profit EMOs, and found that only two of the 413 have closed—a nearly negligible rate of less than 0.5 percent. Interestingly, this was true even though a significant number of the schools (39 of the 413) had later terminated their original EMO contracts and shifted to self-management or some other form of management. Thus the conclusion is that having an EMO *at startup* is the key risk-reduction factor.

The Kauffman Foundation team focused on for-profit EMOs because a rich dataset on their charter schools was available from a 2004 study by scholars at Arizona State University. The Foundation’s hypothesis is that nonprofit EMOs would offer similar risk reduction since their services and features, aside from the nonprofit status, are similar.

Although it has not yet been determined exactly why an EMO at startup reduces risk, some obvious possibilities present themselves. One reason may simply be that the EMO’s experience helps a new school get established on a sound footing. Also, the EMO provides “another set of eyes” at the pre-launch screening stage. While every plan for a new charter school must be approved by a state board, the involvement of an EMO means that an interested third party has judged the basic idea to be viable, figuring that there will be sufficient demand for a new charter school in the given location, and so forth. Finally, EMO-run charter schools tend to be larger than average, which also correlates with lower risk (see the next section).

On the other hand, it is possible that the EMO itself, as distinct from the school, can fail. The most notable instance was the August 2004 failure of California Charter Academy, a regional for-profit EMO in California. Charter schools managed by this firm were not included in the Kauffman Foundation’s studies as it was not yet clear what the real estate consequences would be. The message here is that basic due diligence on the EMO is in order. In general, however:

Kauffman’s findings strongly indicate that charter schools *started* by EMOs pose very low risk to lenders and landlords.

It is not true that “most charter schools will eventually fail but are too new to have failed yet.”

Given the relative newness of the charter movement, another common concern is that most of the schools just haven’t had sufficient time to fail. The Kauffman

Foundation tested this belief by sifting the CER data to remove all schools younger than five years. Five years is a sensible break-point because most charter schools are reviewed by their states for charter renewal at that stage, and schools that are doing poorly may be dissolved then.

Kauffman Foundation analysis showed that for charter schools more than five years old, the cumulative historic closing rate is indeed higher than the all-school average. By CER standards, 13.79 percent of the charter schools reaching an age of five years or more had “closed” compared to 9.41 percent of all charters. Adjusting those figures (as described earlier) to correct for charter schools that had simply been merged, re-absorbed by their school districts, or otherwise “closed” in a way that did not affect real estate risk, the Kauffman Foundation found that the more-than-five-years-old cumulative risk rate was 8.6 percent, compared to 5.95 percent for all charters.

So there does appear to be higher mortality down the line rather than early in life for charter schools. However, the magnitude of the difference does not come close to suggesting that “most” or even a large minority of charters is on track for eventual failure. And as the Kauffman Foundation’s studies have shown, a significant number of midlife failures are the result of real estate problems—not a cause of them.

Ideally, the Kauffman Foundation would like to have had data on default or loss experience of conventional lenders and bondholders who have provided financing for charter school facilities, either directly to individual schools or to their lessors. Unfortunately, we are not aware of a comprehensive database that has this information, though anecdotal evidence suggests that defaults by charter school borrowers have been rare. In the meantime, however, providers of credit enhancement can reduce the risks that lenders or bondholders may confront. This is the last subject to which we now turn.

Federal credit enhancement for charter schools has been helpful but is not likely to be the sole answer.

Recognizing the importance of ensuring sound financing for charter schools, the Department of Education (DOE) has established a “Credit Enhancement for Charter School Facilities Program” that channels funds, on a competitive basis, to other organizations to “credit enhance” charter school loans or leases. So far, Congress has appropriated approximately \$125 million for this program. A key advantage of the program is that it uses federal money as the “last dollars” in, and thus leverages federal support with private money (conservatively, five dollars of private money for every one dollar of federal support).

Though the DOE’s credit enhancement program is clearly critical to filling the financing gap for charter schools, it is not likely to be the only answer, especially if the demand to create charter schools continues to grow.

CONCLUSIONS

Charter schools are not without risk, and the Kauffman Foundation does not recommend that every application for a lease or mortgage should be approved.

However, as this Kauffman Foundation study proves, the actual *real estate risks* of dealing with charter schools are easily over-estimated. It is likely that more deals could be struck that are beneficial to all concerned if the risks are properly understood.

In particular, risk analysis and underwriting standards should take account of the following key findings:

- Charter school “closing” and “failure” rates in existing studies need to be adjusted—usually downward—for purposes of assessing real estate risk.
- Most charter school closings do not leave landlords and lenders with white-elephant facilities that are hard to re-market. On the contrary, the vast majority of such buildings are re-marketed on good terms.
- Simply offering to provide a long-term facility at affordable rates removes a key “cause” of charter school failure, thus helping to ensure both the survival and solvency of the school.
- Charter schools that have been started in conjunction with EMOs pose extremely low risk. Larger schools, and schools started under mature state charter laws, also are less risky than average.
- Credit enhancement providers have an important role to play in reducing the risks that conventional lenders and bondholders confront in financing charter school facilities.

About the Ewing Marion Kauffman Foundation

A private, nonpartisan foundation that became fully funded after the death of donor Ewing Marion Kauffman in 1993, the Kauffman Foundation conducts research and grant-making programs in two fields of interest: educational achievement (focused on K–12 math and science performance in Greater Kansas City) and advancing entrepreneurship across America.

Until recently, the Kauffman Foundation's chief involvement with charter schools has been through educational programs for low-income urban youth in the Kansas City area: all programs offered to students at traditional public schools are offered to charter school students as well. However in the past year, specific attention has turned to the national charter movement. One reason is that a number of charter experiments have produced education models that appear to work well, and are worth propagating. Another is the belief that the Kauffman Foundation, with its expertise in the entrepreneurial process, could help address practical issues affecting these "entrepreneurial" schools. This study of real estate risk is an example.