U.S. Charter Schools 2019 Sector Outlook: Despite A Stable Outlook, Disruptions Could Leave Their Mark

January 16, 2019

For U.S. charter schools, rating performance in 2018 resulted in fewer upgrades and downgrades compared with both 2016 and 2017, and S&P Global Ratings believes the sector's outlook for 2019 will continue being stable. The nature of the sector lends itself to inherent risk and volatility, where charter nonrenewal or revocations can affect credit quality swiftly. However, the majority--83%--of rated issuers continue to carry stable outlooks.

We believe the sector will maintain stability overall despite slowing growth of charter schools and increasing support for stricter standards, given that education reform was a central debate in the midterm elections. The stable outlook reflects the higher credit quality of rated issuers (compared to the charter universe), increasing per pupil funding levels (which we expect will continue in 2019), and growth of charter school networks. The sector is still expanding, but more slowly. Compared with four or five years ago when the rated universe was growing by 40-50 ratings each year, only six public ratings were added in 2018. We believe this reflects the sector's increasing financing opportunities and options beyond rated debt available to charter schools, as well as investors' increased appetite for high-yield unrated debt. We expect that our ratings will increasingly reflect more established charter schools, which generally have less credit volatility than newer schools.

Overall, our stable outlook on the sector includes more risks than opportunities. While federal government support for school choice remains strong, the midterm elections resulted in significant political leadership changes, and given the key role that these state leaders play in education, we believe there could be material implications for charter schools. The laws and support for charter schools can vary significantly from state to state, and we believe some regions will be more at risk than others. In addition, economic risks, continued unionization, and other potential disruptors outweigh the strength of opportunities (such as increasing parity funding, the proliferation of school networks, and continued mergers and acquisitions). Should some of the broader risks (such as a slowing national economy) occur, local governments could face more credit stress, which could affect per-pupil funding for charter schools. There are also the credit risks inherent in the sector, such as failure to meet authorizer standards, charter nonrenewal due to academics, or enrollment shortfalls.

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Risks And Opportunities

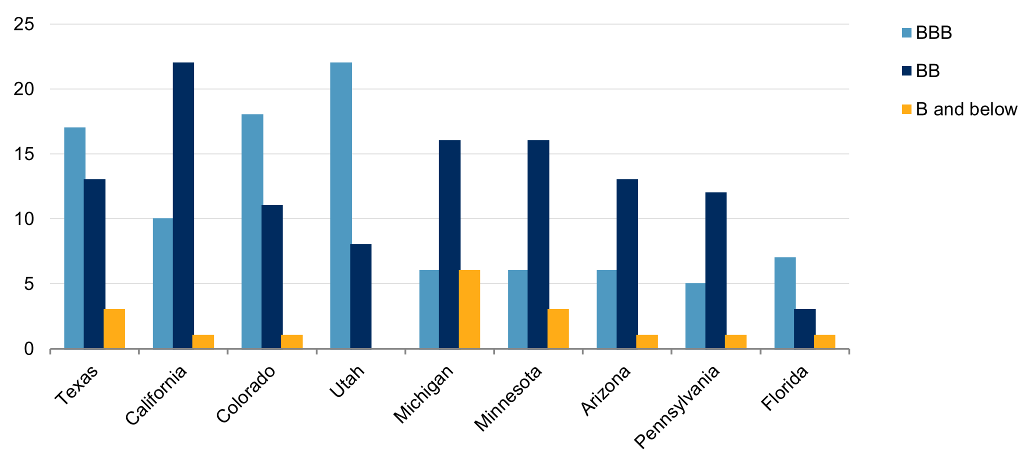
Risks	Opportunities
- Midterm election changes and loss of charter advocates in some states - Potential disruption from growth in unionization - Projected slower economic growth that could negatively affect per-pupil funding - Rising interest rates - Continued governance-related risks	- Increasing parity funding discussions and improving legislation in some states - Proliferation of networks - Continued merger and acquisition activity, which usually benefit enterprise profiles and credit quality

Overview Of Sector Ratings

As of Dec. 31, 2018, S&P Global Ratings has 281 public ratings on charter schools in 25 states. Texas continues to have the largest amount of publicly rated charter school credits (32), while Colorado and Utah follow closely behind, with 30 rated charter school credits each (see chart 1). Certain states such as California and Texas have large charter school networks with multiple schools supporting a single rating. During 2018, we added six new public charter ratings, two of which were in Nevada. The chart below reflects the number of obligated groups issuing rated debt, and not the number of schools or networks, for the states in which we have 10 or more.

Chart 1

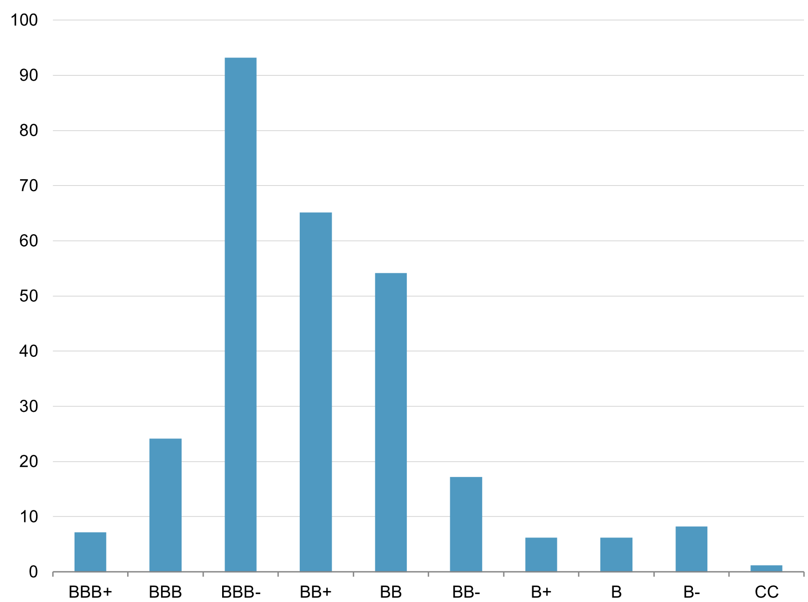
State-By-State Ratings Distribution



Our charter school ratings range from 'BBB+' to 'CC'. We have only one issuer rated below 'B-', which indicates our belief that there is at least a 50% probability of payment default. Stride Academy, Minn. (CC/Negative), intends to miss its April 1, 2019, bond principal payment as permitted under the Conditional Waiver Agreement that the academy signed with the trustee. Management informed us that it does not plan to use the bond debt service reserve to cover the principal payment and the 'CC' rating is in line with our view that a default is virtually certain. The negative outlook reflects our expectation that the April 1, 2019, bond principal payment will not happen as scheduled, constituting a 'D' (default) rating under our criteria.

Chart 2

2018 Ratings Distribution

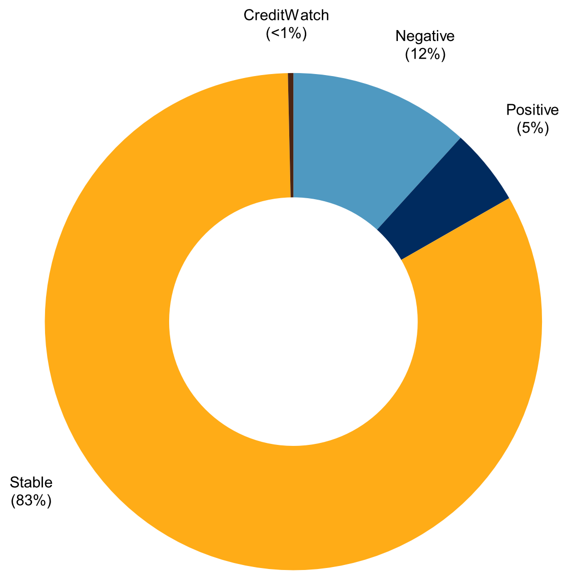


Source: S&P Global Ratings. Data as of Dec. 31, 2018.

Approximately 56% of our ratings are either 'BBB-' or 'BB+' (see chart 2), and while 83% of the ratings currently carry a stable outlook, negative outlooks (33) outpace positive ones (14; see chart 3) highlighting the significant pressures facing individual schools within the sector.

Chart 3

2018 Outlook Distribution

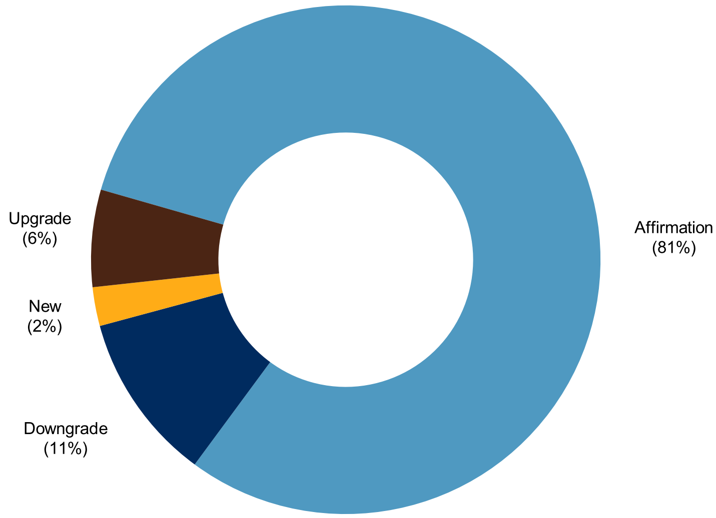


Source: S&P Global Ratings. Data as of Dec. 31, 2018.

Although charter schools on negative outlook continue to significantly outpace those with a positive outlook, this ratio has improved during the past three years. In addition, we affirmed 81% of the charter school ratings overall in 2018 (see chart 4), reflecting an overall stabilization of ratings for the sector compared with previous years. Based on these trends, we anticipate that the majority of our rated charter schools will remain stable in 2019.

Chart 4

2018 Rating Actions



Source: S&P Global Ratings. Data as of Dec. 31, 2018.

In our opinion, a charter school must maintain a good working relationship with the authorizing body to warrant consideration for an investment-grade rating, and a deteriorating relationship between the school and the authorizer can lead to a multiple-notch downgrade, particularly in those areas of the country where the school has limited ability to substitute authorizers. This is a critical risk particular to the charter school sector.

In 2018, S&P Global Ratings had nine multiple-notch rating actions in the sector (see table); this compares with six in 2017, the year in which we released new criteria. Seven of the 2018 multiple – notch rating actions were downgrades and two were upgrades. While 83% of rated issuers, which continue to mature, are stable, the charter sector is susceptible to some unexpected credit profile changes, which could relate to a sudden issue with the authorizer or a surprise decline in enrollment. Because of this, charter ratings tend to be more volatile than ratings in some other sectors of U.S. public finance.

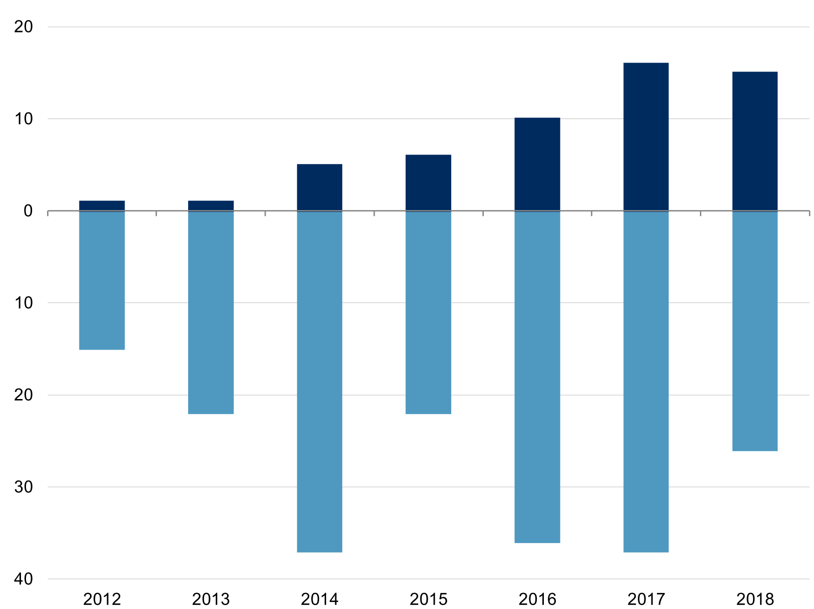
2018 Multi-Notch Rating Actions

School	State	To	From	Date
Cesar Chavez Public Charter School	DC	B-	BB	Jan. 22, 2018
Detroit Service Learning Academy	MI	B	BB-	March 8, 2018
Charter High School for Architecture & Design	PA	B-	CCC+	July 27, 2018
A+ Charter School Inc.	TX	BBB-	BB-	May 1, 2018
Irvington Comnty Sch Inc	IN	B+	B-	May 29, 2018
ASPIRA of Florida Inc.	FL	B	BB	May 31, 2018
Pointe Educational Services	AZ	B+	BB	Sept. 28, 2018
Telesis Center for Learning Inc.	AZ	CCC-	CCC+	Oct. 12, 2018
A.W. Brown Fellowship Charter School	TX	BB	BBB-	Oct. 18, 2018

There were many reasons for the seven downgrades in 2018. These included contingent liquidity risk, deteriorating credit fundamentals caused by declining enrollment, legal compliance issues, and weakening financial performance and covenant violations. None of the charter schools in our rated universe closed in 2018 (although some saw campuses close), and there were no defaults. The two multiple-notch upgrades were due to significantly improved finances in one case, and a legal change related to a school becoming part of a group in the other. While these events aren't uncommon in the sector, we believe these issues represent individual situations and are not indicative of any sector-wide trends.

Chart 5

Sector Downgrades And Upgrades



Source: S&P Global Ratings. Data as of Dec. 31, 2018.

In 2018, we lowered 26 ratings and raised 15 (see chart 5). At the end of the year, 33 ratings are on negative outlook, and 14 on positive. One additional rating is on CreditWatch, which means that we will evaluate this rating with new information that we expect during the 90-day CreditWatch period. As 2019 progresses and we continue to review our charter school ratings, we believe our expectation that the majority of ratings will not change will continue to bear out. Furthermore, as fewer charter schools seek rated debt, rated issuers will continue to reflect more mature and established charter schools with less volatility.

The Midterm Elections: Charter Schools Lose Some Allies

Charter advocates lost some allies in legislatures in the midterm elections. There is still strong federal support for school choice, but after the midterm elections, the house Democratic supermajority in some states could be a credit risk for charter schools, given their ability to circumvent the governor's veto. At the same time, several gubernatorial changes could also prove significant for charter schools, given the key role these state leaders play in education. Because so many critical decisions affecting charters--from authorization to funding mechanisms--are determined at the state level, these political changes could have material impacts. Some of the states that saw political reversals (not just in governorship but in the department of education or legislature majority)--including Colorado, Michigan, California, and Arizona--are home to some of the strongest charter school enrollments, and the election outcomes suggest that expansion during our outlook period could prove difficult.

Midterm election changes in some states could be a credit risk for charter schools.

In 2017, Kentucky became the 44th state (including the District of Columbia) to adopt a charter school law, and in 2018, charter law did not change in any state. Under the Kentucky law, local school districts, as well as the mayors of Lexington and Louisville, can authorize charter schools. However, a year later, no charter schools have opened in the state, because lawmakers have not finalized regulations or created a permanent funding mechanism. Montana, Nebraska, North Dakota, South Dakota, Vermont and West Virginia remain the six states with no law authorizing charter schools.

Selected States To Watch In 2019

California: In California, where more than 1,250 charter schools serve over 600,000 students, Democrat Tony Thurmond, a two-term assemblyman, became the state superintendent of public instruction, defeating contender, Marshall Tuck, who had been a charter school executive. Mr. Thurmond, a strong advocate for public schools, has argued for limiting charter schools, and in his first press conference after winning, he called for a temporary ban on any new kindergarten-grade 12 charter schools in the state. The governorship remains Democratic, with Gavin Newsom replacing long-time Governor Jerry Brown, and both houses have a Democratic-led supermajority. During his campaign, Mr. Newsom indicated he would seek a moratorium on charter school openings to consider changes to state law to improve accountability and transparency.

Arizona: Democrat Kathy Hoffman is Arizona's new state superintendent of public instruction-elect, succeeding Republican Diane Douglas. During the campaign, Ms. Hoffman, a speech therapist who worked in school districts, emphasized her time in the classroom and her goal to make charter schools more accountable. At the same time, Republican Doug Ducey was re-elected governor and the legislature remains Republican-led. The governor supports charter schools and voucher programs but has discussed backing charter school reforms, based on increased transparency and accountability. We will monitor any legislative initiatives for their credit impact. Also, voters rejected a ballot initiative that would have allowed a modest school choice program to expand. In 2018, we saw the introduction of the Arizona Charter School Enhancement Program, which creates a lower-cost financing option for qualifying charter schools. In 2019, we expect continued use of this program.

Michigan: In Michigan, Democratic Governor-elect Gretchen Whitmer won her race for governor against the state's Republican Attorney General, Bill Schuette. Michigan is Education Secretary Betsy DeVos' home state, and she has been an outspoken proponent of charter schools nationally, but Governor-Elect Whitmer campaigned to "end the DeVos agenda" in Michigan, which does not bode well for charter expansion and funding.

Illinois: In Illinois, Democrat Governor-Elect J.B. Pritzker, who campaigned on limiting charter school growth, defeated incumbent Republican Bruce Rauner, a supporter of charter schools. Meanwhile, Chicago Public Schools has denied all new charter applications for the next school year. Finally, Chicago Mayor Rahm Emmanuel, who has supported charter school growth since he took office in 2011, has announced that he will not run for re-election in 2019.

New York: In New York, the election results could mean a significant shift in support for charter schools. Many of the Democrats elected to the senate have expressed opposition to charter school operators. So while there are more than 100,000 students in hundreds of New York City charter schools, it does seem highly likely that the legislature will restrict the number of new charter schools and tighten regulations on existing ones.

Colorado: Democrat Governor-Elect Jared Polis founded two charter schools and has been an advocate for education technology and charter school issues. Mr. Polis takes office with Democrat majorities in both chambers of the general assembly. Colorado voters rejected Amendment 73, which would have raised tax rates on corporations and the wealthy, as well as changed assessment rates for commercial and residential property. Amendment 73 was projected to raise an additional $1.6 billion a year for Pre-K through 12 education, including charter schools.

Further Unionization And Strikes Could Cause Disruptions

While only about 11% of charter schools nationwide are unionized, unionization efforts in charter schools increased in 2018, and we expect this to continue in 2019 given the success so far. Teacher unions have generally viewed charter schools as competition for resources and students, but recent declines in union membership have led teacher unions to join forces with their historical adversaries. National teachers' unions have suffered membership losses due in part to the Supreme Court's Janus ruling in 2018 (which ruled that non-union workers covered by collective agreements do not have to pay fees to public-sector unions) and have been investing in organizing charters.

In January 2018, the Chicago Teachers Union (CTU) merged with the largest charter union in the country, Chicago Alliance of Charter Teachers. Chicago is one of the cities with the most unionized charter schools in the U.S., at about 25% of total charters. This includes the teachers at Acero Charter School Inc., who went on strike in 2018. The strike, the first at a U.S. charter school, lasted four days and resulted in higher teacher pay and smaller class sizes, which could motivate further unionization efforts (for more information, see "From Union Ballots To Election Ballots: A Look Back At The Top 10 Credit Stories Affecting U.S. Charter Schools In 2018," published Dec. 20, 2018, on RatingsDirect). CTU members have reported they are bargaining with other charter operators, and educators (contracted through Civitas Education Partners, an education management organization) at four of Chicago International Charter School's 14 campuses have already voted to authorize a strike if negotiations break down. In Chicago, about 31 of its charter schools are unionized. New York and Los Angeles also have significant numbers of unionized charter schools. Los Angeles has the most, at 92, representing about one-third of its charter schools. However, unlike in Chicago, it seems unlikely that the teacher unions in Los Angeles will cooperate with charter schools, particularly since the United Teachers Los Angeles union went on strike Jan. 14, 2019, demanding a cap on charter schools as part of contract negotiations. In New York City, about 10%, or 21, of its charter schools are unionized. With the city close to reaching its maximum cap on charter schools, it is unclear whether New York teacher unions and charter schools will forge a partnership.

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For the most part, charter schools tend to operate on lower, more flexible budgets than traditional public schools, because the majority do not have unions and are insulated from many state and district regulations. Continued unionization within the charter school sector could mean better wages, benefits, or working conditions for those teachers, but it could reduce financial flexibility for those schools, or cause disruption with more strikes.

Projected Slower Economic Growth Could Hamper Per-Pupil Funding

Following the Great Recession in 2008, most states cut student funding significantly. While state legislatures have gradually increased this funding, the majority are still funding below pre-recession levels. Charter schools have benefited from a strong economy recently and this has translated into higher per-pupil funding in most states. But S&P Global Ratings' economists think that this economic cycle is either in--or fast-approaching--its latter stages. According to our recent economic forecasts, supply-side limitations and higher interest rates from the Federal Reserve will likely weigh on GDP growth next year. (For more on our 2019 economic projections, see "The New Year Will Likely Ring In A Record U.S. Expansion; Could It Be A Last Hurrah?", published Dec. 4, 2018). S&P Global Ratings views the chance of a recession over the next 12 months to be 15%-20%, up from 10%-15% earlier last year. History shows that, should states

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squeeze their budgets in 2019, reductions to state shared revenues for local governments will likely follow. This would be particularly problematic for charter schools, who rely heavily on these revenues, don't generally tend to carry significant reserves, and don't typically have local revenue-raising flexibility. The impacts from slower economic growth could vary greatly by state, but for some, it could mean material reductions in per-pupil funding.

At the same time, changing demographics have ratcheted up competition for students between public schools and charter schools in some states. Enrollment in public elementary and secondary schools is projected to increase very modestly during the next few years, but the disparity in growth rates between states is striking. Federal projections expect enrollment to rise in the nation's South and West, but decline materially in the Northeast and Midwest. Because enrollment and per-pupil funding are key credit factors in our analysis, any material changes could impede credit quality. While state legislatures have gradually increased funding, the majority are still funding below pre-recession levels.

Rising Interest Rates Could Translate Into Less Market Activity

Total charter school bond issuance was down approximately 18% in 2018 at about $2.7 billion, from $3.3 billion in 2017. In 2018, advance refundings and qualified zone academy bonds were eliminated, but the preservation of private activity bonds and new market tax credits was a significant win for the sector and preserved the status quo. Meanwhile, interest rates have risen slowly over the past year, although still lower than pre-2009 levels. With the expected continued rise in interest rates, we believe the sector will likely face decreased capital market activity in 2019. However, we think that this reduction will be somewhat limited, because even with slightly higher rates, bond financing can still provide significantly lower rates than many other forms of capital financing for charter schools. We believe that, even with a decrease in market activity overall, demand for low-investment-grade or high yield paper will continue being significant, as investors continue to seek higher yields through speculative-grade or unrated paper.

Governance-Related Risks Continue

"Headline Risk" has increased across the education sector, and charter schools are no exception. We witnessed several cases in 2018, from single-site charter schools to larger networks. The majority of these incidents related to management and governance issues that we believe charter schools will continue to face. Two large networks terminated founders due to sexual harassment allegations, while other cases included allegations of financial malfeasance. In each case, our initial assessment indicated that there was no immediate impact to credit quality, but we continue to monitor developments. As risks to charter schools arise from less traditional areas--such as governance scandals and further unionization or strikes--we believe management teams will need to address increasing questions regarding transparency and sufficient and timely disclosure. (For more information on how we incorporate governance factors into our analysis, see "Through The ESG Lens: How Environmental, Social, And Governance Factors Are Incorporated Into U.S. Public Finance Ratings," published Oct. 10, 2018.)

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Parity Funding Discussions Increase And Legislation Improves In Some States

Parity funding conversations and legislation continue across the nation in charter states. For most, this comes in the form of splitting or sharing the local property taxes, but in some cases, the discussion is about bringing charter school funding more closely to 100% of the local districts' per-pupil spending. Adopting the latter certainly helps the charter schools' financial operations, and if that translates to a track record of improved operating margins or stronger balance sheets, we could consider them credit positives.

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In 2018, two of the states in which we rate the most charter schools, Colorado and Michigan, passed legislation focused on parity funding. In Colorado, legislation requires school districts that collect revenues from mill levy overrides (voter-approved property taxes beyond the state minimum) to share increases with charter schools that they authorize, beginning in fiscal 2020. It will also create a mill levy equalization fund to distribute state money to the Charter School Institute's 41 schools. Because no local school board approved these schools, they would otherwise not be eligible for these revenue increases. In Michigan, legislation allowed charter schools to receive revenue from some voter-approved property tax increases. Previously, these taxes were given to counties' traditional school districts on a per-student basis, on top of their state funding, but the new law makes charters eligible to receive a share of the extra local funding. In Florida, charter advocates and legislators passed an education law, HB 7069, in June 2017, but several of the state's largest school districts continue to fight against this legislation 18 months later. From a funding perspective, these bills move charters schools in the states to more-equal footing with district schools. For many schools that had not received a perceived fair share of these revenues historically, this will likely have a significant impact on per-pupil funding and improve overall financial flexibility.

Most recently, on Jan. 1, 2019, a new public school revisions law, House Bill 313, took effect in Utah. It repeals the Utah Board of Education's authority to approve or deny charter applications and gives this power to the Utah Charter School Board. The statute also removes the Board of Education's control over the Charter School Board itself. Furthermore, members of the State Charter School Board will be appointed by Governor Gary Herbert and confirmed by the Senate. Until 2019, the Board of Education had the authority to nominate members, and no confirmation was required. Under this new statute, the Board of Education can only set minimum criteria for authorizing charter schools, and it only has the authority to order review of charter school applications that fall short of those standards.

Networks Continue To Proliferate

Although the majority of charter schools are independent, there has been increasing growth in charter schools run by management organizations. There are several reasons for this trend. Philanthropic foundations and federal policymakers have promoted the growth of charter management organizations (CMOs) and education management organizations (EMOs) to run schools, and some of the benefits proponents of management organizations cite include economies of scale, centralized governance and management oversight, sharing of best practices, and ease of replication and growth. In addition, as more stringent authorization requirements, and increasing real estate and labor costs heighten the barriers to entry, management organizations tend to have greater financial resources to replicate or start a new school. We expect this growth trend to continue, albeit not evenly across states. From a rating perspective, we don't distinguish between management organizations and independently run schools, or CMOs and EMOs, but

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assess the relevant credit factors pursuant to our criteria.

The primary difference between the two types of management organizations is that CMOs are nonprofit while EMOs are for-profit. EMOs often undertake land acquisition and development as well as school management. Both types of organizations are networks of schools managed by a central leadership team that provides shared academic, human resource, back-office, operational, and financial services and holds the charter for the network of schools. Pursuant to a contract with the board, fees for both organizations can range from 3%-15% of state aid revenues.

Continued Merger Activity

As the number of charter schools continues to increase nationwide, consolidation and mergers within the sector also continue at a steady pace. While rated charters represent only a small fraction of existing charter schools, in 2018, we saw two distinct mergers within the approximately 300 charter schools we rate. One was KIPP Texas, the consolidation of four charter school networks into a single statewide organization, to streamline operations, create efficiencies and economies of scale, and allow for expansion plans--a distinct situation. The other merger, between one rated charter school and an unrated charter school, is perhaps more indicative of what we expect we will see more of in the sector--a merger for geographic or facilities expansion. In our view, mergers can provide opportunities for cost reduction, managerial synergies, enrollment growth, or facility expansion. Within the sector, we have seen smaller or poorly performing charter schools seek the expertise and stability that a more mature enterprise can offer. As the sector faces greater challenges from increased competition and stricter regulations, we expect merger opportunities might become a more common solution for struggling charter schools.

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Beyond 2019: Pensions And Other Benefits Could Prove Costly

Although most charter schools are not unionized and are exempt from many state and district regulations, most participate in their respective state's pension plan. As the burden of unfunded pension and other postemployment benefit liabilities increases, the cost is passed on to participating school districts and charter schools. Therefore, in states with low funded ratios, schools are seeing increasing required pension and other post retirement contributions. Our assessment includes a forward-looking view of changes in assets and liabilities, funded ratios, and funding discipline. Per our charter school criteria, we view low pension plan funding ratios and a failure to cash fund actuarially determined contributions or statutorily required contributions in full, negatively. We expect to see possible rising pension and retirement obligation costs for schools in certain states, which could further soften EBIDA margins and debt service coverage. We will continue to evaluate each individual school's financial flexibility and ability to manage any additional cost burden. For a more thorough look at our views on pension and OPEBs, see "S&P Global Ratings' U.S. Public Finance 2018 Pension And OPEB Research Recap," published Dec. 13, 2018. This report does not constitute a rating action.

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