

# MUNICIPAL BOND MARKET NOTE

## JANNEY FIXED INCOME STRATEGY

March 28, 2012



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## Charter School Basics

### Charter Schools Currently Possess Widespread Bi-partisan Political Support and Evidence Shows Performance is Generally Better Than Traditional Options

- Charter schools are public, not private schools where school administrators gain educational independence in exchange for increased accountability. Charter school tax-exempt debt is secured primarily by per-pupil state aid revenues.
- Individual state law determines the structure for charter schools and there are state by state differences (sometimes significant), including variations in state aid revenue, oversight mechanics, enhancement programs, and other available funding.
- Evidence in support of the charter school movement has shown that charters can offer a more effective and safer learning environment compared to many traditional alternatives.
- The majority of charter schools are rated BBB or lower or do not have underlying ratings. This is largely because they possess some speculative credit characteristics.
- No investment grade rated charter school has ever defaulted and only one defaulted charter school was rated at the sub-investment grade level.
- Only 15 out of 478 (3.1%) charter schools defaulted on debt payments from 1998-2010.

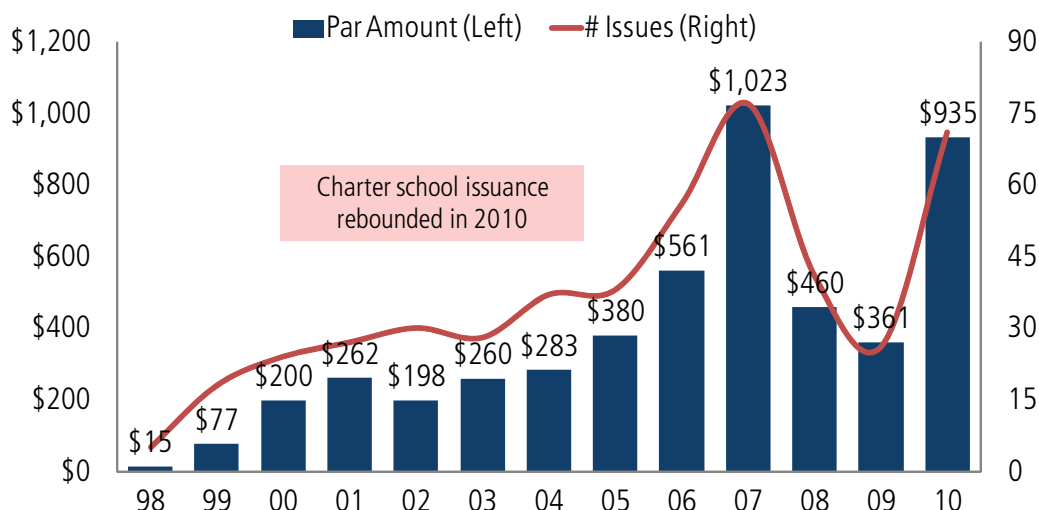
### Investment Perspective Series on Charter Schools

The first of three publications meant to provide a focus for investors on the charter school sector; this report covers charter school sector basics. The next will review the sector's credit strengths and weaknesses, and the last will identify the relative value opportunities available in the sector.

## CHARTER SCHOOL BASICS

There are few public policy issues that evoke more attention and emotion than that of the deterioration of the U.S. public school system and the resultant debate about school choice. Dedicated educators and parents have tried to mend U.S. public education failings for some time because decades of ineffective fixes and finger pointing resulted in falling graduation rates and sub-par student perform-

### Charter School Bond Issuance



Source: Local Initiatives Support Corporation and Janney FIS. \$ in millions.

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"It's time to admit that public education operates like a planned economy, a bureaucratic system in which everybody's role is spelled out in advance and there are few incentives for innovation and productivity..."

"...It's no surprise that our school system doesn't improve: It more resembles the communist economy more than our own market economy." — Albert Shanker, former American Federation of Teachers President and activist, *The Wall Street Journal*, October 2, 1989.

Charter schools are often a very rational preference.

ance. This was documented in a high-profile educational report in the early 1980s. While reports from Presidential commissions on the topic of education have been increasingly common since the six volume account titled, "Higher Education for American Democracy," was made to Harry S. Truman in 1947, none of them garnered the attention that the 1983 National Commission on Excellence in Education report titled, "A Nation at Risk: The Imperative for Educational Reform" received after its release.

"A Nation at Risk" is sometimes most remembered for some of its opening lines, which helped produce a broader awareness of the declining status of the U.S. educational system:

- "...the educational foundations of our society are presently being eroded by a rising tide of mediocrity that threatens our very future as a Nation and a people," and
- "If an unfriendly foreign power had attempted to impose on America the mediocre educational performance that exists today, we might well have viewed it as an act of war."

## Enter the Charter School Movement

In 1992, some entrepreneurs launched a country-wide revolution in local education when they founded the nation's first charter school. Today, there are more than 4,800 charter schools that serve 1.8 million students across the U.S., according to the National Alliance for Public Charter Schools. In 1998, the Concord Academy in Petosky, MI sold \$1.3 million of unrated debt, the first revenue bonds secured by a charter school. There have been 478 rated and non-rated charter school bond financings totaling over \$5 billion sold from 1998-2010 per, "Charter School Bond Issuance: A Complete History," published by the Local Initiatives Support Corporation (LISC), June 2011. After a dip in issuance in 2008 and 2009, charter school financings rebounded in 2010 as parents, local leaders, and charter school administrators continued to exchange educational independence for increased accountability. We expect this trend to continue in the near term as demand remains strong and bipartisan political support for the charter school option continues.

## CHARTERS ARE PUBLIC, NOT PRIVATE SCHOOLS

Charter schools are often a very rational preference considering traditional educational alternatives. Enrollment in charter schools is frequently a sensible response to social, governmental and politically imposed complexity. The need and/or demand for charter schools would not exist without current barriers to the efficient and effective delivery of educational services which exist in many of the country's public school systems. As such, many charter schools are located in larger urban areas that contain extensive labor and political forces opposed to reform, and are typically more common in areas which possess poor socio-economic profiles.

A charter school is a public school independent from the local school district, typically receiving public funds in the form of per-pupil state aid payments. Charter school students pay no tuition. The charter school is granted a contract (or the charter) to operate the school for a specific period of time, generally about 5 years, but this, along with many other charter school provisions, differs state by state (Please see table on page 7). A charter oversight authority will typically review student performance on a regular basis. Experience suggests that problems with student performance are more effectively solved under structures with more oversight and goal setting.

Individual state law determines the legal environment for charter schools. Such legislation includes guidance about:

- Maximum number of schools allowed to be opened,
- Types of schools (missions and focus),
- Organizations approved to grant charters.

The organizations that grant charters also vary state to state. In some states, the local school district authorizes charter schools. In other examples, statewide agencies or public universities execute this function. An important note for investors is that the stronger the relationship between a charter granting entity and a charter school, the more likely a charter will be renewed.

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The number of charter school students increased by almost 80% since 2005-2006.

The number of charter schools has increased by almost 40% since 2005-2006.

"...charter schools look to be serving students well, at least in elementary and middle schools, and probably better in math than in reading," Betts and Tang study.

## Charter School Proliferation Trends

The enrollment in charter schools increased almost 80% since 2005-2006, making them one of the fastest increasing school choice options around. Charter schools sprang up quickly in several states as part of the U.S. housing boom, and in other cases, as an effective school choice alternative in troubled or distressed school systems. Accordingly, charters proliferated in states such as AZ, CA, CO, FL and TX partly related to expansion, and in LA, PA and MI mostly as alternatives to traditional school systems.

### Charter School Enrollment and Schools Have Increased Substantially (Select States)

State/Location	# of Charter School Students (2010-11)	Increase in # of Charter School Students Since (2005-2006)	Number of Charter Schools (2010-2011)	Increase in # of Charter Schools (since 2005-2006)	% of Charter School Students to All Public School Students (2010-2011)
National	1,825,233	79%	4,859	38%	4%
Arizona	125,284	38%	506	2%	12%
California	365,207	84%	917	66%	6%
Colorado	73,445	66%	167	37%	9%
Delaware	9,525	45%	19	46%	7%
DC	29,366	65%	52	0%	39%
Florida	155,233	68%	462	38%	6%
Georgia	48,394	83%	97	73%	3%
Illinois	41,714	146%	46	59%	2%
Louisiana	37,030	234%	90	210%	5%
Massachusetts	28,422	29%	63	7%	3%
Michigan	113,481	24%	242	12%	7%
New York	54,527	153%	170	115%	2%
Ohio	114,275	59%	340	18%	7%
Pennsylvania	90,954	63%	147	27%	5%
Texas	165,471	151%	275	41%	3%

Source: National Alliance for Public Charter Schools Data Resource and Janney FIS.

## Educational Performance Comparisons - A Controversy

The volume of research comparing charter school academic performance with their traditional competitors has grown significantly during the last few years. Some studies (see various reports at the Center for Research on Education Outcomes at [www.credo.stanford.edu](http://www.credo.stanford.edu), for example) have cynically reported that charter school performance is about the same, mixed or even worse when compared to traditional school performance. However, at the end of 2011, two University of California economists, published a study titled, "The Effect of Charter Schools on Student Achievement: A Meta-Analysis of the Literature," Oct. 2011. This study, by Julian Betts and Emily Tang, reviewed the studies that compared performance and found that:

"...charter schools look to be serving students well, at least in elementary and middle schools, and probably better in math than in reading."

We would like to recognize that the Betts and Tang study will definitely not be the last word on this topic and that plenty of criticism of charters still exists. And while overall attitudes toward the sector are partly influenced by such studies, we advise investors to not lose sight of the fact that it is the performance of individual charter schools that is related to the per pupil state aid payments that secure bond payments. Overall, we have observed more positive evidence supporting charter schools and their growth. This is despite continuing pessimism regarding the effectiveness of charter schools. Our more optimistic view reflects our belief that charters can offer a more effective and safe

The majority (over 80%) of charter school backed tax-exempt debt falls into the BBB rated, sub-investment grade, or non-rated categories.

The majority of charter school bond issues are not guaranteed by the local public school, state or local government. However, a small number do include enhancements.

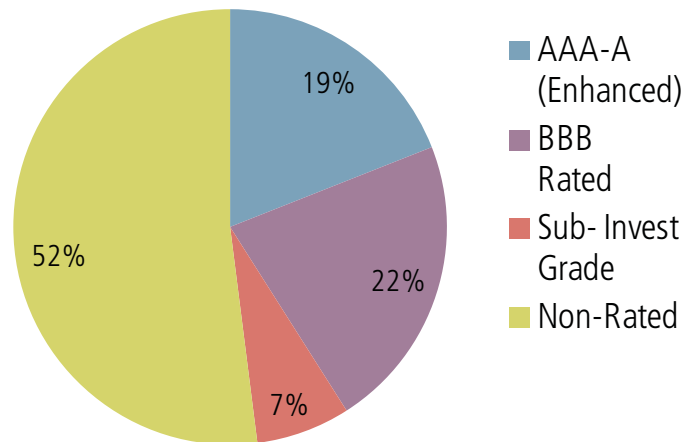
Charter schools are generally funded by state governments on a per-pupil basis, usually in an amount close to what is paid to traditional public schools.

learning environment for students.

## CHARTER SCHOOL TAX-EXEMPT BOND MARKET

Charter school bond issuance increased significantly in recent years, and today there is over \$5 billion of tax-exempt charter school debt outstanding. We expect issuance in this sector to continue steadily. The majority (over 80%) of charter school backed tax-exempt debt falls into the BBB rated,

### Charter School Issuance by Rating



Source: Local Initiatives Support Corporation, June 2011 & Janney FIS

sub-investment grade, or non-rated categories. This is mainly due to the speculative nature of the underlying credit profiles of the issuers. The issues that are rated "A" or above all possess some type of special credit enhancement. There are currently no underlying ratings above the BBB category. Special credit enhancements include state moral obligations, state enhancements and loan guaranty programs. Several states offer per-pupil funding specifically for facilities. Please see the Appendix B on page 8 for more state by state details.

### Unique Credit Enhancements for Charter Schools

**Texas-** Investment grade charter bonds are eligible for the State Permanent School Fund

**FL, NM-** Some charters are eligible for tax levies

**CO, IN, UT-** Some charters are eligible for state moral obligation credit

**DC, MA, MI, TX —** Provide partial funding, loan programs or administration services

Source: Janney FIS.

### General Security for Charter School Bonds

Charter schools are generally funded by state governments on a per-pupil basis, sometimes but not always, in an amount close to what is paid to traditional public schools. In most states, this state-aid needs to cover a charter's operating and facilities costs (some programs help cover facilities costs, please see the Appendix on page 8 for a "Summary of State Charter School Facility Funding and Financing Programs.") Investors should understand that charter schools have no pricing power: they cannot adjust prices in order to increase revenues. Most do not have the ability to levy taxes, and in many cases, do not receive capital funds from their respective states. A positive point about the security structure for some issues is that they often include a mortgage interest on certain property.

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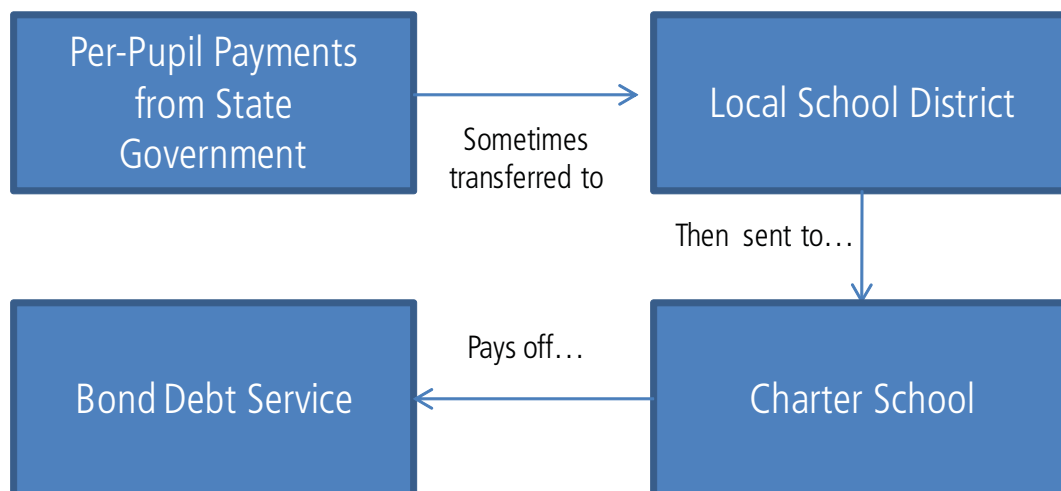


Charter Schools do not possess taxing power and do not possess the flexibility to raise revenues if necessary for their individual entity.

No investment grade rated charter school has ever defaulted.

Recoveries ranged from 18% to 80% for defaulted charter school bonds.

## General Security for Charter School Debt



Source: Janney FIS.

## Preview of Charter School Default Experience

Investors should note that no investment grade rated charter school has ever defaulted, although overall sector default rates are higher than most municipal sectors. A number of rated charter issues have been either downgraded below investment grade or had their ratings withdrawn for a lack of information. The Local Initiatives Support Corporation (LISC) June 2011 report highlighted some conclusions that can be drawn from the charter school default experience.

## Charter School Bond Default Rates by Security Type

Type	Default (#)	Rate	Default (\$)
Investment Grade, 198 issues	0	0.0%	\$0.00
Non-Investment Grade, 31 issues	1	3.2%	\$2.60
Non-Rated, 251 issues	14	5.6%	\$116.90
Total of 478* issues	15	3.1%	\$119.40

Source: LISC, June 2011 and Janney FIS. \*2 issues had rated and unrated series.

## General Conclusions from Charter School Default Experience

Factor	Detail
Bond Rating	No investment grade has defaulted, only 1 non-inv grade defaulted
Type of School	All were stand-alone schools, no networks
Size of School	Avg enroll 330 and 6 schools had less than 200 students
Age of School	Average age was 4 years and 5 schools 3 years or less
Quality of Credit Analysis	Many of the 3.1% likely not have been sold under current standards
Notable Deficiency	Lack of information about student performance
Recovery (% bonds)	Ranged from 18% to 70%, weighted average of 55%

Source: Local Initiatives Support Corporation, June 2011 and Janney FIS.

LISC reports (available at [www.lisc.org](http://www.lisc.org)), are valuable references and have contributed significantly to analysts' and bondholders' understanding of the charter school sector.

## SOURCES AND ADDITIONAL READING

1. "The Effect of Charter Schools on Student Achievement: A Meta-Analysis of the Literature," Julian Betts and Emily Yang, National Charter School Research Project, October 2011.
2. "Charter School Bond Issuance: A Complete History;" Local Initiatives Support Corporation; June 2011. The LISC reports (available at [www.lisc.org](http://www.lisc.org).) are valuable references and have contributed significantly to analysts' and bondholders' understanding of the charter school sector.
3. "Charter School Performance in Pennsylvania," Center for Research on Education Outcomes, April 2011.
4. "2010 Charter School Facility Landscape," Local Initiatives Support Corporation; June 2010. sector.
5. "Multiple Choice: Charter School Performance in 16 States," Center for Research on Education Outcomes, 2009.
6. "A Nation at Risk: The Imperative for Educational Reform," A Report to the Nation and the Secretary of Education by the National Commission on Excellence in Education, April 1983.

## Analyst Certification

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## Major Provisions of State Charter School Laws

State	Charter Granting Bodies	Charter Duration (Years)	Subject to Caps on Growth?	NAPCS Charter School Law Ranking (2011)
Alaska	Local school boards	Up to 5	None	40
Arizona	Local and state school boards and state charter board	15	None	14
Arkansas	State school board	3	Some	17
California	Local, state (multi) school boards	5	Yes (but room)	9
Colorado	Local school boards, statewide Institute	3-5	None	7
Connecticut	State school board	5	Yes (but room)	29
Delaware	Local for conver; local or state board for new schools	4	None	22
Washington DC	DC public charter board (2007)	15	Yes (but room)	11
Florida	Local school boards	4-5	None	3
Georgia	State school board	5-10	None	15
Hawaii	State school board	4 (then 6)	Yes (but room)	35
Idaho	Local and state school boards	Up to 5	Yes (but room)	32
Illinois	Local school boards with state board review	5-10	Yes (but room)	24
Indiana	Local and state boards, colleges, and uni	7 (avg)	None	5
Iowa	Need local then state board approval	4	None	38
Kansas	Need local then state board approval	5	None	39
Louisiana	Local and state school boards (mostly state)	5	None	13
Maine	Local school boards	5 (then 15)	Yes (but room)	1
Maryland	Local school boards	N/A	None	41
Massachusetts	Local for conver; state board for new schools	5	Yes (but room)	6
Michigan	Local school boards, colleges, univesities	Up to 10	Yes (but room)	10
Minnesota	Local school boards, colleges, univesities	3	None	2
Mississippi	Local and state school boards	3-6	Yes (but room)	42
Missouri	Only allowed in Kansas City and St. Louis	5-10	Yes	18
Nevada	Local and state school boards	6 (3 renew)	Yes (but room)	20
New Hampshire	Need local then state board approval	5	Yes (but room)	19
New Jersey	State education commissioner	4	None	31
New Mexico	Local and state school boards	5	Yes (but room)	4
New York	Local and state school boards and SUNY board	5	Yes (but room)	8
North Carolina	Local and state school boards, colleges, and uni	10	None	33
Ohio	Local and state school boards	Up to 5	Yes (but room)	28
Oklahoma	Local school boards	5	Yes	27
Oregon	Local and state school boards	Up to 5	None	21
Pennsylvania	Local school boards	3-5	None (*Philly)	16
Rhode Island	State school board	Up to 5	Yes	26
South Carolina	Local school boards (State prelim app)	10	None	25
Tennessee	Local school boards	10	None	30
Texas	Local for conver; state board (mostly)for new schools	5 (then 10)	Yes (but room)	23
Utah	Local and state school boards	No limit	Yes (but room)	12
Virginia	Local school boards	3-5	None	37
Wisconsin	Local school boards, some high ed	Up to 5	Yes (but room)	36
Wyoming	Local school boards	Up to 5	None	34

Source: National Alliance for Public Charter School, Fitch Ratings and Janney FIS.

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## Summary of State Charter School Facility and Financing Programs

State	Per Pupil Funding for Facilities	Other Grant Funding	Loan Program	Credit Enhancement	Conduit Issuer	QZAB Eligible	QSCB Eligible
Alaska					■	■	■
Arizona	■				■	■	■
Arkansas						■	■
California	■	■	■		■	■	■
Colorado	■	■		■	■	■	■
Connecticut		■			■	■	■
Delaware					■	■	■
Washington DC	■	■	■	■	■	■	■
Florida	■				■		■
Georgia		■			■	■	■
Hawaii						■	
Idaho					■	■	■
Illinois			■		■	■	■
Indiana				■	■	■	■
Iowa							
Kansas					■	■	■
Louisiana			■		■	■	■
Maryland					■	■	■
Massachusetts	■			■	■	■	■
Michigan				■	■	■	■
Minnesota	■				■	■	■
Mississippi							
Missouri					■	■	■
Nevada						■	■
New Hampshire					■	■	■
New Jersey					■	■	■
New Mexico	■	■			■	■	■
New York		■			■	■	■
North Carolina					■		
Ohio						■	■
Oklahoma		■			■		
Oregon					■	■	■
Pennsylvania	■				■		
Rhode Island		■			■	■	■
South Carolina					■	■	■
Tennessee	■				■	■	■
Texas				■	■	■	■
Utah	■	■	■	■	■	■	■
Virginia					■	■	
Wisconsin					■	■	■
Wyoming							

Source: Local Initiatives Support Corporation, June 2010 and Janney FIS.