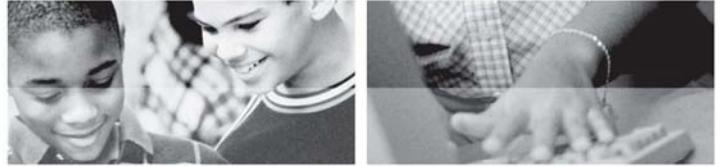


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NONPROFIT REAL ESTATE TRUSTS

Viable Solutions to the Charter School Facilities Challenge

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INTRODUCTION: THE CHARTER SCHOOL FACILITIES CHALLENGE

Over the last decade, charter schools have become a strong source of innovation and inspiration to the public education system, providing high-quality options to more than a million children in 2005, many of whom are among our nation's neediest. But the entrepreneurs who have created those new schools – and those who are working today to create scalable systems of charter schools – have discovered that the financing and developing of school facilities is one of their most persistent challenges. Just like other public schools, charter schools deserve access to adequate, reasonably-priced facilities.

To truly grasp the magnitude of the challenge, it is important to understand how traditional public schools are financed. Traditional public schools receive two different streams of resources: operating funds and capital funds. Operating funds for public schools – used for teacher salaries, instructional supplies, transportation, food service, etc. – come from both local property taxes and from state and federal coffers. Meanwhile, capital funding – for construction, renovation and major repairs – generally comes from the sale of bonds. A state or district issues a tax-exempt bond, approved by voters and usually purchased by banks, foundations, retirement funds, insurance companies and other financial institutions; over time, these bonds are repaid with tax revenues. The proceeds of the bond sale flow to school districts to pay for buildings.

Charter schools receive their operating funds in a similar way to other public schools, with local, state and federal dollars contributing to a per-pupil allocation that “follows the children” to the charter schools they elect to attend. This allocation is typically less than that which district schools receive for their ongoing instructional and administrative expenses¹. Even more troubling, most state charter laws have no provision for facilities funding,² an expensive and crucial piece of the puzzle for any school. Consequently, most charter school operators are forced to pay for facilities costs out of an already slim operating budget – often leaving just 80 percent of their resources available to support instruction. This state of affairs forces charter schools to divert critical time, resources and funding away from educational purposes. Two additional factors worsen the problem:

- **Access to Capital.** Charter schools need long-term, high-quality school facilities. However, charter schools are generally granted a short-term charter that lasts five years, with annual evaluations, and can lose their charter for poor performance or financial mismanagement. As a result, charter school operators face a number of challenges in raising the equity capital and securing the debt needed to pay for facilities. In most states, they are unable to issue tax-exempt debt, which is how traditional school districts finance their capital purchases. Further, financial institutions are often nervous about lending to individual schools because of this concern about their longevity, leading charter schools to access capital through more expensive, nontraditional lenders, which considerably increases risk to the school. These same concerns have made foundations hesitant to provide philanthropic dollars to charter schools for facilities, for fear that the money intended to benefit the charter school and its students could wind up with a private landlord if a charter school is forced to close.
- **Inexperience in Real Estate.** Excellent charter school teams have expertise in education, instructional management and business operations – but rarely in real estate. With incomplete and inexperienced real estate teams, most charter schools are unable to manage the risk and uncertainty of real estate planning and development and as such are apt to make poor facilities decisions. Real estate mistakes can be extremely costly and can put a school's survival at risk – especially when mistakes cause a facilities deal to fall through after significant funds have already been invested.

¹ A 2005 study of charter school funding inequities found that average charter school funding fell short of the funding allocated to surrounding district schools by more than 20 percent, or \$1,801 per pupil. The same study found that lack of access to capital funding was one of the primary drivers of this shortfall. See “Charter School Funding: Inequity's Next Frontier,” by Bryan Hassel and Sheree Speakman for the Thomas B. Fordham Institute, August 2005.

<http://www.edexcellence.net/doc/Charter%20School%20Funding%202005%20FINAL.pdf>

² Several states are exceptions to this rule, setting aside monies for charter school lease aid or capital funding. These states include Arizona, District of Columbia, Florida, Massachusetts and Minnesota.

A study commissioned in fall 2002 by NewSchools and conducted by the consulting firm Brody, Weiser, Burns confirmed that charter schools simply do not have sufficient access to affordable facilities financing – especially in the early years, when such access is most critical – and most lack the specialized expertise to effectively manage the real estate development and financing process.

Indeed, this is one of the highest hurdles in the development of new charter schools and systems of schools, and is a challenge that threatens to stall the growth of both individual charter schools and charter school systems, particularly in dense, high-need urban areas like Los Angeles, New York City and Washington, D.C. What's more, this situation skews charter schools' accountability equation, under which they are expected to deliver improved academic results in return for freedom from many state and local mandates. By requiring them to accomplish this task with fewer resources than other public schools, charter schools are forced to compete with traditional public schools on an uneven playing field.

Some public, private and philanthropic players have begun to address this problem by helping improve charter schools' access to capital (through lease aid, loan guarantees or loan pools) or to public resources (such as public school facilities and bond proceeds).³ NewSchools Venture Fund believes the crux of the problem is that charter school operators and systems are forced to excel in two businesses simultaneously: the business of educating our nation's most underserved children, and the business of real estate development. Facilities financing and development are simply not core competencies of a charter school team, nor should they be. The goal of every charter school should be to better serve public school students. As such, we need to get charter school operators out of the real estate business.

A PROPOSED SOLUTION: THE NONPROFIT REAL ESTATE TRUST

NewSchools Venture Fund believes that one viable solution is to create nonprofit real estate trusts (NRETs) that serve as expert intermediaries. Simply put, these organizations would acquire, develop and lease education facilities to a broad portfolio of charter school operators, with revenue coming from development fees and rent. By aggregating capital from multiple sources and consolidating expertise within the organization – rather than in the principal's office or the central office of a charter management organization – the trust would lower the financial and human cost of real estate development and enable greater access to facilities funding. If successful, a NRET could provide a reasonably secure vehicle for lenders interested in charter schools, a strategic investment for philanthropic organizations interested in charter quality and scale, and a way to focus policymakers on the importance of charter school facilities.

The model is based in part on a solution called the “Public Schools Real Estate Trust,” proposed by Paul Hill of the Center on Reinventing Public Education, for the management of traditional public schools. “The Trust would own all public school buildings and oversee the district's capital expenditures,” says Hill. “The Trust would have three key features. First, it would have a clear mission: to ensure that all publicly funded schools ... have timely access to the space they need. Second, the Trust would be flexible; it would have the freedom and incentive to use a variety of tools to make sure every publicly funded school has a place to thrive. Third, the Trust would be accountable: the district and community could create clear criteria for judging its performance based on its mission.”⁴ One such public school trust has already been created in Portland, Oregon.

A nonprofit real estate trust focused on charter schools would shine a light on and direct resources to those schools that face this challenge most acutely: successful and promising charter schools. The trust could serve all types of charter schools, including individual schools and schools run by charter management organizations, but could make tenant decisions based on evaluation of a charter school's likelihood to succeed both academically and financially. As a result, we believe nonprofit real

³ For more about the various solutions to the inequity of charter school facilities finance, see “A Building Need,” *Education Next*, Spring 2004, pages 44-51. <http://www.educationnext.org/20042/pdf/44.pdf>

⁴ See “How Business and Civic Leaders Can Make a Big Difference in Public Education,” by Paul Hill for CEOs for Cities, April 2004. http://www.ceosforcities.org/research/2004/Leaders_Can_Make_a_Big_Difference.pdf

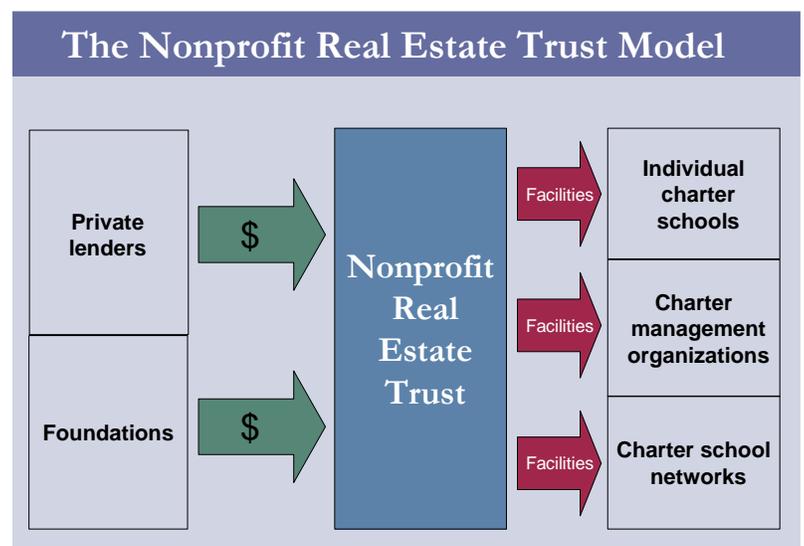
estate trusts will dramatically transform the charter school facilities landscape, allowing the most promising schools to secure high-quality, affordable facilities.

The nonprofit real estate trust model has benefits for many of the stakeholders involved in charter school facilities finance, including charter school leaders themselves, foundations and lenders.

- **Charter school leaders.** This model can provide charter school leaders with high-quality, low-cost facility options. By design, an NRET can justify building a strong real estate team, and can spread the cost over many facility deals. Facilities development is hard and complex work, requiring a number of specific tasks (including site identification, acquisition, financing, construction and renovation) that are rarely done well by those without experience. The NRET assembles an expert and experienced team with construction management skills, lender and contractor relationships, and the expertise to navigate the legal and government approvals processes, thus avoiding costly, time-consuming negotiations. Further, by managing the development and occupancy of a building, the NRET assumes the cost of excess capacity while a charter school increases its enrollment (and thus its revenue) and “grows into” the space. This saves charter school operators from diverting resources away from other key priorities in order to pay for unused space.
- **Foundations.** Many charitable foundations that support charter schools or systems recognize that facilities are a challenge, but have not stepped forward to fund facilities explicitly. By pooling their capital with other philanthropic funds and investing in a NRET with deep real estate planning and development expertise, donors gain a highly leveraged way to spur the growth of the charter school movement and a partner to ensure that funds are spent wisely and ultimately re-circulated. Finally, by separating the real estate asset from the school until the school is financially stable, the NRET helps to further lower each foundation’s risk by ensuring that the school facility will be used by another charter school operator in the event a school is not re-authorized.
- **Lenders.** The intermediary reduces risk to lenders – and itself – through its ability to replace tenants. As a manager of charter school facilities, and not a school owner or operator, the NRET oversees a tenant pipeline and maintains deep knowledge of the local charter school market. This allows the organization to replace a tenant if one school loses its charter or falls on hard times. What’s more, the NRET may be able to raise more capital as collateral for its loans because of a simple advantage over individual charter schools or systems: each investment or grant by a funder in the NRET benefits multiple charter school organizations.

Under this model, charter school facilities can be secured at a lower cost, allowing both charter school operators and lenders to reallocate resources – namely time, attention and capital – to their core competencies. Charter school leaders, who are often passionate educators, can exit the real estate side of the charter school business, and redirect their attention toward teaching and learning, rather than the physical space within which it occurs. Capital providers, on the other hand, can focus their resources on creating financing structures, leveraging capital, and managing portfolio risk – rather than trying to build deep expertise in charter schools.

Over time, the nonprofit real estate trust could become sustainable by using development fees to cover operations and the sale of facilities to generate capital for future projects. This “recycling” of capital would eliminate the need to raise additional philanthropy over time. One way of doing this would be to provide charter schools with a pathway to ownership by giving financially strong schools the



option to buy their buildings (presumably after at least one charter renewal) and freeing up previously invested funds for the development of additional charter school facilities. Under these circumstances, the NRET would act as any other real estate developer, but one with a social mission. (Note: Not all schools will – or should – own their facility, even in the long term. Some will prefer to lease their facility indefinitely, creating an ongoing need and a well-rounded tenant portfolio for these trusts.)

EARLY EXAMPLES OF THE MODEL

Since 1998, NewSchools Venture Fund has been working to transform public education for underserved students by investing in promising education entrepreneurs. One of the major areas of focus in this strategy has been supporting charter school entrepreneurs who are building charter management organizations (CMOs), scalable nonprofit systems of charter schools that are centrally managed. Through this work, NewSchools recognized the convergence of two important trends: the demand for new, high-quality public schools was increasing, even as the charter school entrepreneurs who sought to create such schools faced mounting difficulty in financing and developing facilities. In order to ensure that the charter school movement continued to grow and serve the needs of underserved children, NewSchools believed that the time was right for intermediary organizations like nonprofit real estate trusts to be developed.

In 2002, NewSchools invested in Civic Builders⁵, an organization in New York City that had begun to work toward relieving charter schools there of the burden of navigating one of the most complex and competitive real estate marketplaces in the world. Civic Builders had been founded by entrepreneur David Umansky and incubated at the Greenpoint Manufacturing and Design Center, a nonprofit commercial real estate development company for small manufacturing enterprises. The organization originally served as an advisor on facilities finance and development to charter schools in New York City, but with funding support from NewSchools and other investors has since evolved into a full-service real estate development firm. In October 2003, Civic Builders bought its first charter school facility – a 24,000 square-foot former salami factory in the Hunts Point section of the Bronx – which was renovated and now houses the Bronx Charter School for the Arts, serving 280 high-need New York City students. Today, the organization is working on additional facilities, including the development of a former parking garage into a school building for the Bronx Lighthouse Charter School, which will eventually serve 520 K-12 students in a new school created by charter management organization Lighthouse Academies, an emerging CMO.

At the same time, NewSchools recognized the immense value that a similar organization could provide to the Los Angeles market. In 2003, NewSchools began to “incubate” a brand-new venture, Pacific Charter School Development (PCSD)⁶, that could serve the growing number of charter schools and CMOs in the area. Former charter school executive Glenn Pierce – who has been involved in the development of more than thirty charter schools across the country – was brought in to develop the business plan and lead the new organization. Today, the organization is staffed by an experienced team with deep expertise in real estate project management who identify, acquire and develop charter school facilities that will in turn be leased to academically successful CMOs. In its first five years, PCSD plans to develop nearly 30 new charter school buildings, which together will serve more than 11,000 students. The organization will focus initially on the creation of facilities in the Los Angeles Unified School District, complementing the district's own massive, multi-year building program designed to address overcrowding and predicted enrollment growth in the area. In the fall of 2005, PCSD opened 1200 new “seats” for students, with more than 2500 new seats planned in each of the next four years in partnership with growing CMOs like Aspire Public Schools, the Alliance for College-Ready Public Schools, Green Dot Public Schools, Inner City Education Foundation and Partnerships to Uplift Communities.

In addition to the direct impact that these two organizations are having, nonprofit real estate trusts can also have a catalytic impact on the broader education landscape. For example, Civic Builders has become a thought leader within the New York

⁵ For more information on Civic Builders, see <http://www.civicbuilders.org>.

⁶ For more information about Pacific Charter School Development, see <http://www.pacificcharter.org>.

charter school sector, particularly on the subject of school facilities. The leaders of both Civic Builders and PCSD have made presentations at numerous conferences and meetings designed to help educators, philanthropists and policymakers work through the complex challenges and opportunities on the charter school facilities landscape. They have also helped pave the way for entrepreneurs in other geographies who may wish to tackle this challenge. Over time, NewSchools believes the success of nonprofit real estate trusts can help demonstrate the importance of enabling charter schools to focus on instruction rather than facilities.

STARTING NONPROFIT REAL ESTATE TRUSTS IN OTHER GEOGRAPHIES

Nonprofit real estate trusts could help meet school facilities needs in a number of cities across the country. The basic objectives of the NRET – freeing up school leaders to focus on learning, and separating the development and management of the real estate asset from the charter school operation – is applicable across geographies. However, there are a number of criteria or market conditions that if present would maximize the viability and impact of the organization. These include:

- ***Friendly charter environment.*** Nonprofit real estate trusts are best positioned to scale and achieve sustainability in markets without a cap on the total number of charter schools that can be authorized. NRETs in markets with a cap may have difficulty raising operational and capital dollars if potential donors perceive that the model's ultimate impact or sustainability could be hindered by a lack of future charter school supply.
- ***High concentration of quality charter schools with facilities needs.*** In order to reach sustainability, nonprofit real estate organizations must work in markets where there are a sufficient number of charter schools – and perhaps more importantly, new or existing CMOs that expect to open multiple schools. In a market with multiple CMOs, an NRET can develop partnerships that can yield predictable, diversified growth, thus creating potential for significant economies of scale.
- ***Challenging real estate market.*** In markets where the competition for real estate is intense and the regulatory/policy environment is particularly complex, charter schools' needs for professional but affordable management assistance increases.
- ***Collaborative school district relationships.*** Certain school districts have indicated a willingness to partner with charter schools in a way that that could help decrease the combination of philanthropy and debt a nonprofit real estate trust needs to reach sustainability. For example, NRETs would benefit from working in markets where the district has made surplus school buildings available for alternative uses, or has agreed to use its capital dollars to partner with CMOs or real estate developers on developing school buildings. In Philadelphia, the school district has partnered with a successful CMO, allowing the CMO to renovate and use a district facility. In New York City, the district is setting aside its own capital dollars to leverage private investment and expedite the development of facilities for charter schools. A number of other districts have sold or leased surplus school buildings to charter schools; still others have provided space for charter schools to co-locate with traditional schools in the district.
- ***Supportive ecosystem.*** NRETs are complex organizations that must navigate the real estate market, the education system, and the public policy arena. To do so successfully, a NRET will need to cultivate a strong base of funders, board members, policy makers, advisors, and partners.
- ***Availability of philanthropy.*** Entrepreneurs starting nonprofit real estate organizations must raise a significant amount of capital to get this model off the ground, usually from a combination of local and national funders. There are currently only a handful of national foundations willing to support this model, although the number is growing. As such, local philanthropy is crucial to the development of new NRETs.

If the conditions detailed above are in place, there are at least two potential starting points for entrepreneurs who want to launch nonprofit real estate trusts in other high-need communities. In one scenario, an existing nonprofit real estate

organizations such as a community development financial institution could develop a subsidiary or spin off an independent entity designed to meet the facilities needs of local charter schools. This is similar to the way Civic Builders was launched. The advantage here is that an established organization – with a track record, access to human and financial capital, a deep knowledge of the local real estate market, and relationships with the real estate, philanthropic and political communities – is strategically positioned to respond to demand from charter school entrepreneurs. A second scenario would involve an entrepreneur taking a “bootstrap” approach. Here, the entrepreneur would likely combine knowledge of education, facilities and the local real estate market with fundraising ability in order to start a brand new NRET.

Both of these scenarios are extremely capital-intensive. As such, prospective entrepreneurs need to focus early on philanthropic and capital support, a strong board of directors, and a “hybrid” management team with experience across the public, private and nonprofit sectors that can demonstrate success quickly.

NEWSCHOOLS VENTURE FUND’S ROLE AND A CALL TO ACTION

NewSchools Venture Fund is a venture philanthropy firm working to transform public education by supporting education entrepreneurs. As an intermediary between donors and education ventures, NewSchools seeks to have a dramatic impact on the public education system – both by enabling all school systems to become performance-driven organizations and by facilitating the growth of nonprofit charter school systems.

Solving the charter school facilities challenge is crucial to this latter piece, as this barrier currently impedes the growth of both individual charter schools and charter school systems like CMOs. Thus, NewSchools’ charter school facilities initiative has three main goals:

- **Accelerate** the growth of the charter school movement by easing access to low-cost facilities.
- **Enhance** charter school quality by freeing their leaders to focus on teaching and learning.
- **Demonstrate** a sustainable, scalable facilities solution for charter schools.

Ultimately, we believe this work will help catalyze large-scale public and private financing of charter school acquisition and construction, allowing charter school facilities to take their proper place as a publicly funded obligation of our public school system.

Although NewSchools has worked to seed and support early-stage nonprofit real estate trusts, there is more work to be done. Individual donors – particularly those with experience in the real estate business – can help jump-start these organizations with early-stage funding and support. Foundations must step forward to support these organizations in their later stages, potentially with program-related investments (PRIs) and other innovative instruments that leverage their endowment assets to support the expansion of charter school facilities and the strengthening of the charter school movement; because they can be backed by tangible assets (real estate and school buildings), supporting these efforts with PRIs poses less risk than other education investments might. Leaders from the business, finance and real estate fields are needed to serve on the executive teams or boards of these organizations, bringing to bear their expertise in management and operations. And perhaps most importantly, it is crucial for entrepreneurs with a passion for improving public education and knowledge of the charter school market to step forward and create a critical mass of nonprofit real estate trusts.