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Ratings

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KIPP Bay Area Schools, California; Charter Schools

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KIPP Bay Area Schools, California; Charter Schools

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ICR		
Long Term Rating	BBB/Stable	New

Rationale

S&P Global Ratings assigned its 'BBB' issuer credit rating (ICR) to KIPP Bay Area Real Estate (KBARE), which represents the KIPP Bay Area Schools (KBAS)-Obligated group, Calif. The outlook is stable.

An ICR reflects the obligor's general creditworthiness, focusing on its capacity and willingness to meet financial commitments when they come due. It does not apply to any specific financial obligation because it does not take into account the obligation's nature and provision, standing in bankruptcy or liquidation, statutory preferences, or legality and enforceability.

KBARE is a California not-for-profit corporation formed to finance, develop, lease, and maintain school facilities for KBAS. KBAS is a California not-for-profit corporation established in 2002 with the opening of Bridge Academy in Oakland, the first KIPP Bay Area school. Today, KBAS operates a network of 15 schools via 14 authorized charters serving more than 5,700 students in fall 2018. Two of these schools serve elementary students, six are middle schools, three offer grades kindergarten-8, and four are high schools. All of the schools are in the San Francisco Bay area. KBARE has two sole members, KIPP Bridge and KIPP Heritage, which constitute the obligated group. KBARE acquired a $16 million loan from the Charter Impact Fund (CIF) to refinance two construction loans from Pacific Charter School Development and to reimburse KBAS for previous equity contributions.

Revenues of the two obligated KBAS schools secure the loan. Based on our group rating methodology criteria, published July 1, 2019, our rating analysis encompasses the entire KBAS organization, given the network approach to general strategy and shared oversight. Specifically, our highly strategic group assessment is based on the two schools' role and importance to KBAS. We view the obligated group as important to the organization, with parent support of the obligated group likely in the event of operating difficulties; however, the obligated group only represents only 17% of total organization enrollment and revenues, which limits our view of the group status to highly strategic. The ICR applies only to KBARE, which represents the obligated group--not to KBAS as an organization. Financial metrics cited in this report reflect those of the entire KBAS organization unless otherwise specified.

We assessed KBAS' enterprise profile as strong, characterized by growing enrollment, solid demand with a healthy waitlist and good academics, and a sophisticated and highly capable management team. We assessed KBAS' financial profile as adequate, supported by consistently positive operating performance; robust unrestricted reserves; and healthy, pro forma maximum annual debt service (MADS) coverage. This is offset by management's aggressive expansion plans and lease-renewal risks, as 12 of the 15 school facilities are leased. We believe that combined, these credit factors lead to an indicative standalone credit profile for KBAS of 'bbb+'. The 'BBB' ICR is based on our group credit profile on KBAS and our view that the obligated group is highly strategic to the organization. Given the obligated group's highly strategic status, the ICR is one notch below that on the group credit profile.

The rating reflects our view of:

- Growing enrollment and ample demand;
- KBAS' exceptional liquidity, with unrestricted cash and investments of over 420 days' cash on hand as of June 30, 2018;
- The schools' history of excellent full-accrual operating surpluses resulting in solid MADS coverage;
- Sophisticated management team with sound governance practices, solid fundraising history, and thoughtful strategic planning efforts; and
- A healthy state funding environment.

Partly offsetting the above strengths, in our view, are:

- KBAS' plans for rapid expansion in the medium term, which inherently present some uncertainties and risks;
- Potential dilution in fiscal 2019 operating performance versus prior-year levels as KBAS invests resources to improve Bridge Academy's academic performance; and
- The potential that KBAS' various charters could be revoked or not renewed as a result of noncompliance with the terms of the charters (as with all charter schools) prior to the bonds' final maturity.

KBAS is part of the larger KIPP (Knowledge is Power Program) network of schools that was formed in 1994. Over 220 schools in 20 states and Washington, D.C., serving almost 100,000 students, are part of the larger KIPP network. About 90% of KIPP's students are from low-income families and are eligible for the federal free or reduced-price meals program.

Total pro forma debt, including the CIF loan, is expected to be approximately $20 million. The loan is secured by revenues of the related schools in the obligated group as well as a mortgage on the real estate owned by each limited-liability company associated with each school. Proceeds of these prior debt obligations were used to construct the KIPP Heritage Academy facility, a $10 million middle school project. This facility, completed in 2017, is located on a portion of the Los Arboles Elementary School. The second loan to be refinanced is related to an annex to KIPP Bridge Academy, a $10.05 million expansion project to house the newly established elementary grades when the school expanded from just middle school to offering grades kindergarten-8. This facility, completed in 2018, is located in Oakland next to KIPP Bridge's main school building, which is leased to KBAS by the Oakland Unified School District.

Outlook

The stable outlook reflects our expectation that over our two-year outlook period, KBAS will continue to grow enrollment and maintain its enterprise profile strength. We also anticipate that KBAS will prudently manage its growth, and continue to generate good operating surpluses and steady fundraising so that its liquidity and MADS coverage remain commensurate with the rating. We expect to evaluate the entity's expansion plans relative to the organization's profile once there is further clarity.

Downside scenario

We could lower the rating if any enrollment or funding pressures constrain operations or the issuance of material additional debt leads to sustained MADS coverage or liquidity considerably below current levels.

Upside scenario

We are unlikely to raise the rating during the outlook period given the organization's planned expansion. Uncertainty surrounding proposed legislation that could affect KBAS' market position also limits potential for an upgrade. However, we could consider raising the rating beyond this timeframe if KBAS is able to maintain its enterprise profile characteristics, sustain healthy MADS coverage and robust unrestricted reserves, and successfully absorb additional debt.

Enterprise Profile

Economic fundamentals

KBAS' 15 schools are all in the same region. The schools are concentrated in five areas: San Francisco, Oakland, San Jose, San Lorenzo, and East Palo Alto. About 33% of students (majority) attend schools in San Jose, which is in Santa Clara County. The county's minor population is robust at about 613,000 and is expected to grow at a healthy projected 3.3% growth rate through 2024.

Industry risk

Industry risk addresses the charter school sector's overall cyclicality and competitive risk and growth by applying various stress scenarios and evaluating barriers to entry, levels and trends of profitability, substitution risk, and growth trends observed in the industry. We believe the charter school sector represents a moderately high credit risk when compared with other industries and sectors.

Market position

We view KBAS' demand profile as very healthy. KBAS' total enrollment was 5,766 students in fall 2018, compared with 5,259 in the prior school year. Waitlists were good, in our view, with about 2,475 students on waitlists for fall 2018. Total waitlist increased by about 75 from fall 2017. Growth is expected to continue, with plans calling for significant expansion over the next five years. Two new schools opened in 2018: an elementary school in Oakland and a high school in San Jose. Over the next seven years, future plans call for seven additional schools. At full capacity in 2024, these new schools--combined with the completed expansion of KBAS' currently operating schools--are expected to serve approximately 10,000 students. This would represent an increase of 74.7% over the 2018-2019 school year enrollment. Although there are other local charter schools, KBAS' ability to increase enrollment consistently demonstrates a solid demand position, which we do not expect to change despite the competitive environment in California.

KBAS has demonstrated sound academic performance overall, with most schools outperforming the district and state averages in most categories. The academic scores for KIPP Bridge are below state averages, but in line with, and in most cases better than, local peers'. KBAS has taken necessary steps, including the placement of two of its senior principals at KIPP Bridge, to help improve the academic performance of the school. We view the school's overall academics as respectable and expect they will support the school in its long-term growth plans.

In keeping with the KIPP network, about 77% of KBAS' students are from low-income families and are eligible for the federal free or reduced-price meals program; 96% are persons of color. In our opinion, KBAS has successfully navigated the needs of its student demographic; we anticipate it will continue to do so.

State per-pupil funding has been improving; and proposals for next year indicate base funding could continue to increase by about 3%. We view the schools' standing with their authorizers as good. Each school within KBAS operates pursuant to its own charter contract issued through nine different authorizers. Management reports that KBAS' charters are in good standing. All of the schools have charters that expire in 2020 or thereafter. We anticipate that KBAS will continue to meet authorizer requirements and maintain a positive relationship with the districts.

Management and governance

KBAS is governed by a board of directors that consists of 20 voting members. The board can have as many as 27 members, and directors serve up to three three-year terms and may be reappointed. The board of directors supports the mission of KBAS and members serve voluntarily. KBAS aims to have directors with expertise in real estate, nonprofits, law, finance, management, and philanthropy. The board sets policy for the network, and monitors and oversees the performance of the CEO of KBAS.

Senior management is stable and sophisticated. The CEO has been with the organization since its founding. Administrative staff has increased in recent years to reflect the growth of the organization; senior positions include a managing director of schools, managing director of finance, and chief people officer. KIPP Foundation provides additional leadership training and management resources to KBAS, which we view positively.

Financial Profile

The school's financial performance can be characterized by consistently positive operating margins with excellent lease-adjusted MADS coverage. In fiscal 2018, revenue was about $77.5 million and expenses were $69.4 million, resulting in a surplus of $8.2 million, or a 10.6% margin. This translates to healthy pro forma MADS coverage of 3.09x. The consistent performance can be credited to excellent enrollment growth, increases in state funding, and management's ability to keep expense growth modest. The obligated schools do not have a separate audit, but operations are combined in KBAS' audit. Management anticipates achieving another sound full-accrual surplus for fiscal 2019 and thus maintaining its acceptable MADS coverage for the credit rating. However, given the expectation of continued growth over the next couple of years, we anticipate the added lease expenses for new facilities could pressure MADS coverage if enrollment growth is unable to offset an increased debt burden. Despite this, we view KBAS' operating performance as excellent for the rating category.

Liquidity and financial flexibility

We consider the school's balance sheet a key credit strength providing flexibility at the current rating. KBAS had about $80.4 million in unrestricted reserves as of fiscal 2018 year-end. This translates to an exceptional 423 days' cash on hand, a superior cash position. We understand management anticipates a little under $6 million in capital expenditures for fiscal 2019. Despite the increase in capital expenditures and increased personnel expenses, we anticipate the organization's liquidity will remain healthy for the current rating level.

Debt burden

The pro forma MADS burden is what we consider very low at less than 5% of fiscal 2018 total revenues. KBAS has minimal long-term debt, as it has been successful in combining philanthropic dollars and short-term construction loans to build and renovate its facilities. As a strategy, KBAS is looking to be more flexible by relying less on Proposition 39 facilities--which require annual applications--and pivoting to longer-term facility arrangements. The organization's debt-to-capitalization ratio is remarkably low, given KBAS' low debt. For fiscal 2018, the pro forma debt-to-capitalization ratio was approximately 16%. Management reports that as part of its expansion, it could potentially add to debt during the next five years. We believe the organization has additional debt capacity at the current rating level, given its operating trends, coverage levels, and unrestricted reserves. We will more fully review the effect of any additional debt on the rating once details are finalized.

Financial policies

The school has formal policies for investment allocation, liquidity, and debt. KBAS meets standard annual disclosure requirements. The financial policies assessment reflects our opinion that, while there may be some areas of risk, the organization's overall financial policies are not likely to negatively affect its future ability to pay debt service. Our analysis of financial policies includes a review of the organization's financial reporting and disclosure, investment allocation and liquidity, debt profile, and legal structure, and a comparison of these policies with those of comparable providers.

KIPP Bay Area - GCP, California

Enterprise and Financial Statistics

	--Fiscal year ended June 30--				
	2019	**2018**	**2017**	**2016**	**2015**
Enrollment					
Total headcount	5,766	5,259	4,701	3,814	N.A.
Total waiting list	2,475	2,401	2,784	N.A.	N.A.
Waiting list as % of enrollment	42.9	45.7	59.2	N.A.	N.A.
Financial performance					
Total revenues ($000s)	N.A.	77,543	74,824	65,351	53,455
Total expenses ($000s)	N.A.	69,356	56,845	43,820	35,355
EBIDA ($000s)	N.A.	9,278	18,535	22,071	18,524
EBIDA margin (%)	N.A.	12.0	24.8	33.8	34.7
Excess revenues over expenses ($000s)	N.A.	8,187	17,979	21,531	18,100
Excess income margin (%)	N.A.	10.6	24.0	32.9	33.9
Operating lease expense	N.A.	2,134	987	1,011	1,011

KIPP Bay Area - GCP, California (cont.)

Enterprise and Financial Statistics

	--Fiscal year ended June 30--				
	2019	**2018**	**2017**	**2016**	**2015**
Lease-adjusted annual debt service coverage (x)	N.A.	5.07	16.60	19.24	16.27
Lease-adjusted annual debt service burden (% total revenues)	N.A.	2.9	1.6	1.8	2.2
Lease-adjusted annual debt service burden (% total expenses)	N.A.	3.2	2.1	2.7	3.4
MADS ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.
Lease-adjusted MADS coverage (x)	N.A.	N.A.	N.A.	N.A.	N.A.
Lease-adjusted MADS burden (% total revenues)	N.A.	N.A.	N.A.	N.A.	N.A.
Lease-adjusted MADS burden (% total expenses)	N.A.	N.A.	N.A.	N.A.	N.A.
Pro forma MADS ($000s)	N.A.	3,690	N.A.	N.A.	N.A.
Pro forma lease-adjusted MADS coverage (x)	N.A.	3.09	N.A.	N.A.	N.A.
Pro forma lease-adjusted MADS burden (% total revenues)	N.A.	4.8	N.A.	N.A.	N.A.
Pro forma lease-adjusted MADS burden (% total expenses)	N.A.	5.3	N.A.	N.A.	N.A.
Total revenue per student ($)	N.A.	14,744.8	15,916.6	17,134.5	N.A.
Balance sheet metrics					
Days' cash on hand	N.A.	429.70	443.64	483.83	389.81
Total long-term debt ($000s)	N.A.	6,756	4,882	4,995	4,106
Unrestricted reserves to debt (%)	N.A.	1,226.0	1,439.0	1,178.5	937.1
Unrestricted net assets as % of expenses	N.A.	154.5	148.6	152.8	133.4
General fund balance ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.
Debt to capitalization (%)	N.A.	5.9	5.4	6.9	7.9
Debt per student ($)	N.A.	1,246	1,013	1,279	N.A.
Pro forma metrics					
Pro forma unrestricted reserves ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.
Pro forma days' cash on hand	N.A.	N.A.	N.A.	N.A.	N.A.
Pro forma long-term debt ($000s)	N.A.	19,849	4,882	4,995	4,106
Pro forma unrestricted reserves to debt (%)	N.A.	N.A.	N.A.	N.A.	N.A.
Pro forma debt to capitalization (%)	N.A.	16	6	7	8
Pro forma debt per student ($)	N.A.	3,774	1,039	1,310	N.A.

N.A.--Not available. N/A--Not applicable. MNR--Median not reported. MADS--Maximum annual debt service. Operating lease expense--Annual amount paid in facilities/capital lease payments; excludes equipment/nonfacility lease payments and excludes payments related to principal and interest on bonds. Net revenue available for debt service = EBIDA. Lease-adjusted MADS coverage = (Net revenue available for debt service + operating lease expense) / (MADS + operating lease expense).