

Charter Schools— An Appraisal Challenge

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The charter school movement has taken root throughout the nation and has become an innovative factor in American education. For those concerned with real estate, a charter school presents issues that differ from mainstream conventional educational facilities. Charter schools have a variety of settings, tenure types, and ownership structures. Evaluating these issues is likely to become more important and complex as charter schools become more commonplace.

On March 10, 2009, the charter school movement received an important endorsement from President Barack Obama. In his remarks to the Hispanic Chamber of Commerce, Obama called for increased creativity in addressing educational conditions and recognized charter schools as having a special role:

One of the places where much of that innovation occurs is in our most effective charter schools. And these are public schools founded by parents, teachers, and civic or community organizations with broad leeway to innovate—schools I supported as a state legislator and a United States senator.¹

With support from the White House and the U.S. Department of Education, charter schools are likely to become an increasingly significant part of the American education system. To evaluate the nature of the real estate of a charter school, appraisers should understand the history of the charter school movement, the basic organizational tenets of the program, and the nature of the real estate as well as the operational characteristics and issues.

What is a Charter School?

Charter schools are semiautonomous public schools that are typically founded when a combination of educators, parents, community groups, or private organizations petition a local school board or county board of education for a contract, or charter, to operate independent of the rules and regulations that normally affect public schools. According to *The State of Charter Schools 2000*, a report released by the Office of Educational Research and Improvement, the three reasons most

ABSTRACT

Charter appraisals are often required as part of a lease negotiation as well as for establishing the value of the real estate for finance or establishing a cost basis for highly specialized programs, such as New Markets Tax Credits. This article considers the special real estate issues associated with an appraisal assignment of a charter school. Charter schools have time limitations on their charter, and they have a wide variety of settings, tenure types, and ownership structures. Understanding the history of the charter school movement, the basic charter school organizational structure, and the operational characteristics and issues help the appraiser in analyzing the characteristics of the charter schools, and selecting and applying the appropriate methodologies.

1. President Obama's Remarks to the Hispanic Chamber of Commerce, March 10, 2009, www.nytimes.com/2009/03/10/us/politics/10text-obama.html.

often cited to create a charter school are to realize an alternative educational vision, to gain autonomy and flexibility, and to serve a special population.²

The basic principle that governs the charter is a bargain between autonomy and accountability.³ The charter details the organization and management of the school; which curriculum students will be taught and expected to achieve; and the responsibility of school operators to meet certain measures of performance and success.⁴ The agreement with the local board of education holds charter schools accountable to the market, for economic viability and parent satisfaction, and to government, for financial stability and student performance.⁵ In return, the charter schools can receive exemptions from most state codes and district rules regarding curriculum, instruction, and budget to allow the flexibility to innovate.⁶ These charters are typically granted for 3–5 years and at the end of the term, the entity granting the charter may, or may not, renew the contract.⁷

Proponents of charter schools cite a number of benefits for students, parents, and educators alike. The charter school system increases opportunities for learning and access to quality education through high academic standards, small class size, and innovative approaches. It encourages community and parent involvement in public education because parents and students have a choice within the public school system. Charter schools also create new professional opportunities for teachers and social entrepreneurs.⁸

The Charter School Movement

The charter school movement grew from a variety of reform ideas, including alternative schools, site-based management, magnet schools, public school choice, privatization, and community-parental empower-

ment.⁹ Between the 1970s and the late 1980s, the term *charter* evolved from a suggestion by a New England educator that small groups of teachers should receive contracts to explore new approaches in actual schools-within-schools in Philadelphia. In 1991, Minnesota took the idea a step further by passing the first charter school law and developing charter schools based on the principles of opportunity, choice, and responsibility for results. By 1995, this number had grown to 19 states. Today, the movement has bipartisan support from governors, state legislators, and past and present secretaries of education.¹⁰

Despite the financial struggles of operating a charter school and a general lack of awareness among registered voters,¹¹ these enterprises continue to appear across the country. As of September 1997, 29 states and the District of Columbia had passed charter school laws.¹² Today, there are charter school laws in 40 states plus the District of Columbia. Since the mid-1990s, charter schools have experienced double-digit annual growth, with the number of schools rising rapidly from 250 in 1995 to 4,303 in 2008.¹³ However, growth fell a few percentage points to 9% in 2008 due to market constraints like charter school caps and moratoriums on new schools. Even with these constraints, 362 new charter schools opened in the 2007–2008 school year. Over 1.2 million students from diverse backgrounds are currently enrolled in charter schools across the country. These students comprise 3% of all K–12 students in the United States, representing a 1% increase in market share from 2007.¹⁴

New Orleans has the highest charter market share of any community in the nation, with 57% of its students enrolled in charter schools. According to the “Top 10 Charter Communities” list by the National

2. Beryl Nelson et al., *The State of Charter Schools 2000* (Washington, DC: U.S. Department of Education, 2000), 42.
3. Mark Dean Millot and Robin J. Lake, *So You Want to Start a Charter School? Strategic Advice for Applicants* (Santa Monica, CA: Rand Corporation, 1996), 4.
4. Education Commission of the State, “Charter Schools,” <http://www.ecs.org/ecsmain.asp?page=/html/IssueCollapse.asp>.
5. Millot and Lake.
6. Kyo Yamashiro and Lisa Carlos, “More on Charter Schools,” WestEd (1995), http://www.wested.org/policy/pubs/full_text/pb_ft_more.htm#note1.
7. U.S. Charter Schools, “Overview,” http://www.uscharterschools.org/pub/uscs_docs/o/index.htm.
8. Ibid.
9. U.S. Charter Schools, “History,” http://www.uscharterschools.org/pub/uscs_docs/o/history.htm.
10. Ibid.
11. Only 38% of registered voters accurately described charters as public schools and 47% of registered voters are unsure about charter schools. National Alliance for Public Charter Schools, “Growth and Quality in the Charter School Movement: 2008 Dashboard,” http://www.publiccharters.org/files/publications/file_Charter_Dashboard_2008.pdf.
12. Eleanor A. Perry, “Charter Schools: Friends or Foes?” *Principal* 77, no. 5 (1998): 19.
13. Jeanne Allen and Alison Consoletti, *Annual Survey of America's Charter Schools 2008* (Washington, DC: The Center for Education Reform, 2008); Kenneth Temkin et al., *Implementation of the Credit Enhancement for Charter School Facilities Program* (Washington, DC: U.S. Department of Education, 2008); National Alliance for Public Charter Schools, “Growth and Quality in the Charter School Movement.”
14. Ibid.

Alliance for Public Charter Schools, public charter schools have played a critical role in rebuilding the New Orleans public school system in the aftermath of Hurricane Katrina. In Southfield, Michigan; Dayton, Ohio; and Washington, DC, charter schools hold a 27% market share, while in Pontiac, Michigan, and Youngstown, Ohio, they have a 23% market share. An indicator of growth since the last release of the report is the expansion of the list to include ten communities in nine states.¹⁵

The demand for charter schools at the micro level is dependent on basic demographics (i.e., population of school age children), the quality of educational alternatives, population trends, and the local charter school culture. Several of the communities identified in the top-ten list have grown comfortable with charter schools and they have developed a stable local following. In other communities, public, private, or parochial education is effective and popular; consequently the demand for charter schools is constrained. This factor is important to consider when evaluating the value of specially designed real estate and alternative uses in the event a charter school terminates its operations.

Support for charter schools is not universal and the movement has its critics. The relatively small enrollments limit the statistical significance of performance improvements relative to traditional school populations. There are numerous episodes where charter schools fail, closing after several years of poor performance or poor management. These incidents have prompted criticism and tarnished the movement. Schools that were at one time successful may lose their edge. Innovation fades over time and institutions can lose their personality as the school becomes routine and structured. However, even considering the criticism, the momentum for charter school development has grown, and we are likely to see many new charter schools developed throughout the nation.

Charter School Funding

Charter schools are able to offer longer school days, longer school years, and innovative curricula not

available in traditional public schools, even though they do not receive the same amount of funding from federal, state, and local government. School administrations across the United States fund charter schools at a level that is 39% lower than their district counterparts.¹⁶ Furthermore, charter schools spend more money on students than they receive, in addition to the costs of salaries, benefits, supplies and services, and capital expenditures. In fact, obtaining and paying for permanent facilities is one of the biggest challenges facing charter schools.

As a result, charter schools must look beyond the per-pupil allocations from federal, state, and local aid to fill the funding gap left by already low costs, which can be as high as \$450,000 for a school serving 250 students.¹⁷ One way charter schools have funded operations is through capital campaigning. This strategy can combine public and private grants, individual donations, and online fundraising, among other mechanisms to reach a target.¹⁸

Bridging the finance gap through public and private grants is a highly competitive process. The federal grant programs to which charter schools have access include the U.S. Department of Housing and Urban Development's Community Development Block Grant, and the U.S. Department of Agriculture's Housing and Community Facilities Program.¹⁹ During his campaign, President Barack Obama pledged to double federal spending on charter schools.²⁰ With his stated commitment to educational innovation, federal funding is likely to increase and the stimulus plan will permit funding for charter schools. This will be a major boost to charter school development and operations. The amount of additional funding will depend on competing priorities as well the appropriations dedicated to schools in the package. Private local and national foundations receive countless requests for grants, but conditions like economics or location limit the competition for foundation money.²¹

Charter schools also have access to financing through the New Markets Tax Credit (NMTC) Program. Congress created the NMTC in 2000 to

15. Todd Ziebarth, *Top 10 Charter Communities by Market Share, Second Annual Edition* (Washington, DC: National Alliance for Public Charter Schools, 2007).

16. Allen and Consoletti, 15–16.

17. Allen and Consoletti, 16; Erik W. Robelen, "Charters Receive Less Money Per Pupil, Study Finds," *Education Week* (August 25, 2005).

18. Carol Ascher et al., *The Finance Gap: Charter Schools and Their Facilities* (New York, Institute for Education and Social Policy, 2004), 9; Gwen Solomon, "Finding Funding," *Tech and Learning* (July 15, 2006), <http://www.techlearning.com/article/6034>.

19. Ascher et al., 8.

20. David J. Hoff, "Obama Gets to Work on Transition: Sweeping Triumph May Lift Democrat's Agenda," *Education Week* (November 2008): 1.

21. Solomon.

encourage capital investment in low-income communities. The program permits taxpayers to receive a credit over a seven-year credit allowance period that totals 39% of the cost of an equity investment in a designated community development entity (CDE). In each of the first three years, the investor receives a credit equal to 5% of the total investment at the time of purchase. In each of the final four years, the value of the credit is 6% of the total investment. Investors may not redeem their investments in CDEs prior to the conclusion of the seven-year period.²²

According to the National Community Capital Association, charter schools and their related community development organizations may fit the definition of a qualified community development entity.²³ As a special note to appraisers, NMTC projects involving real estate require the determination of the qualified portion of the tangible assets for calculating the tax credits or eligible basis. The eligible basis is the portion of the real estate that qualifies for the tax credits. If this is the case, the tax attorney or consultant for the charter school should be interviewed to determine the specific issues and definitions for the assignment. In addition, as part of a complex transaction, appraisers often play a role in establishing the as-is and as-renovated value of the property.

The exchange of tax credit allocations for investment capital allow CDEs to make equity investments or loans to charter school facility projects in qualifying low-income census tracts. Typically, CDEs issue a more patient and lower-cost form of capital that provides a number of benefits. These benefits include reduced interest rates; longer amortization or no principal amortization; loan restructuring in the case of repayment difficulty; and debt cancellation.²⁴

Credit enhancements can provide security to reduce loan recovery risk. The most popular type of credit enhancement among charter schools is the loan guaranty. A loan guaranty is a pledge from an individual, corporation, or municipal or federal agency to provide repayment to a lender for outstanding debt

should the charter school default on its commitment. Guaranty amounts range from 15% to 100% of the total loan package.²⁵ The federal budget for the 2009 fiscal year funds the Credit Enhancement program jointly with the State Facilities Incentive Grant program at just over \$21 million.²⁶

Edventurists, or education-focused venture capitalists and social entrepreneurs, have also become involved in the growth of charter schools.²⁷ Organizations like the San Francisco-based NewSchools Venture Fund raise millions of dollars through donations and investments to create charter schools. The majority of this venture capital has gone to support the creation and expansion of charter management organizations (CMOs), which are nonprofits that create and operate clusters of charter schools.²⁸

Local governments use proceeds from impact fees to fund charter school projects. These payments from real estate developers help schools with land and building purchases, construction, and renovation. Most renovation, construction, and acquisition costs, however, are financed with loans. Charter schools typically utilize leasehold improvement loans, construction loans, and permanent loans. These types of loans are the simplest and most common financing tools used by charter schools.²⁹ Another mechanism used primarily to finance capital expenditures is the issuance of bonds. However, this varies from state to state because not all state charter school statutes grant this power.

Real estate appraisers should be familiar with the sources of capital that fund charter schools because it presents a source of risk to real estate owners that lease space to charter schools. The quality of the capital affects the quality and durability of the income stream.

Appraisal Challenges Unconventional Nature of Charter School Real Estate

There is no standard prescription for the physical character of a charter school because local market factors

22. Community Development Financial Institutions Fund, New Markets Tax Credit Program, http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5.

23. Ascher et al., 22.

24. Elise Balboni et al., *2007 Charter School Facility Finance Landscape* (New York: The Educational Facilities Financing Center of Local Initiatives Support Corporation, 2007), 17.

25. Ascher et al., 20.

26. National Alliance for Public Charter Schools, "Charter Schools Facilities Programs," <http://www.publiccharters.org/node/41> (May 13, 2009).

27. Perry, 19.

28. Erik W. Robelen, "Venture Fund Fueling Push for New Schools," *Education Week* (January 2007): 26–29.

29. Ascher et al., 14.

and availabilities determine their real estate values and issues. Many charter schools operate within conventional public school buildings. The school may operate as a school within a school. In this case, the public system arranges for the building and makes a noncash contribution to the charter school. Other institutions often are involved. Churches are another real estate facility that can house a charter school. The charter schools may purchase a church to fit out basements or parish halls and remove pews and religious symbols to provide classrooms. Alternatively, a church may have space available to lease in its school building. Some schools share space with other community businesses in adaptively reused warehouses or multistory office buildings. They may also operate out of the classrooms of community facilities like a local Boys & Girls Club.⁵⁰

Charter schools lack a specific building typology. While there are no specific guideline ratios for classrooms, offices, storage rooms, or parking, the facilities must meet basic classroom standards. Of course, safety issues are always a paramount concern. For an appraiser, if there are costs to bring a building up to safe standards, these costs should be considered in the valuation analysis. Appraisers should dedicate special attention to a facility's previous uses. The prior uses of a building may affect the fair market value of the building, the costs of renovations, and environmental concerns. Obvious examples are properties that might have an environmental history that requires remediation.

Lease Valuations

A charter school typically opens and operates in a leased facility. As a general rule, the school usually does not have sufficient funds, operating history, or enrollment to convince traditional funders, lenders, or landlords to provide long-term mortgage or lease financing for the school's facility. Consequently, a building that needs minimal work is the ideal.

An important factor that affects the operation is the nature of the charter. Because the charter is for a limited period, there is no basis for long-term real estate commitments; as a result, the typical initial space for a charter school is a one- or two-year lease. Once established, charter schools look to the market for appropriate space that can be adapted to their needs.

Charter schools enter into a number of different types of lease agreements. Besides a direct contract with a landlord, some charter schools have a sponsor organization provide space in exchange for the education of a specific population on behalf of the school. Charter schools also engage in leasing with real estate holding companies, which are nonprofit or for-profit intermediary entities that own multiple spaces that can be leased to charter schools. According to NewSchools Venture Fund, banks decrease their risk by making a loan to the holding company because the holding company is responsible for paying the debt and finding new school tenants in the event that a school moves.⁵¹

In a lease-purchase agreement, the charter school makes payments over a given period. Upon the expiration of the lease, the school has the option to purchase the building. Finally, in a sale-leaseback agreement, a school or its school district can sell a building to a private company in exchange for cash and then the company (or in this case, charter school) leases the building back to the school.

Appraisers often play a role in establishing a value for the lease. When establishing this value, it is important to consider that charter schools may be required to pay a relatively high rent. The rent reflects a landlord's risk premium for the uncertainty of the charter; the tenant risk in attracting and maintaining students; and the financial uncertainties of their operations. Commercial landlords are reluctant to provide work letters for tenant fit-up because of the uncertainties. As in any enterprise, the quality of the management team is critical to the success of a project and may offer comfort (or concern) to the parties involved in the transaction. If the charter school is well managed with an experienced administrator and supported with strong financial backing, it is a more attractive tenant.

Finding Comparables and Market Data

For the appraiser, finding comparable leased properties is often a challenge. Leases of properties that were constructed as schools are relatively infrequent and the market for comparables may be broader than for the typical appraisal. In addition to the typical adjustments for location and size, an appraiser may consider adjustments for building condition, proximities,

30. Joe Nathan and Karen Febey, *Smaller, Safer, Saner Successful Schools* (Washington, DC: National Clearinghouse for Educational Facilities, 2001); Ascher et al., 9.

31. Ascher et al., 11.

location of population centers, fit-up requirements, lease terms, etc. These are all critical factors.

In many areas, there has been a decrease in parochial school enrollment. Consequently, these schools have been on the market and the local religious organizations may be a good source of school lease data. Many other charter schools are in building conversions. For properties that were built for another purpose, a good practice is to evaluate the property both as a school and at the alternative highest and best use. In other words, if the charter school is going into a converted industrial space, it would be advisable to consider the likely rental both as a school and for reversion to the highest and best use in the local market.

Valuation Issues

In nonlease situations, there may be a need for a complete market value estimate of the property for financing or a subsidy program. While all three approaches—sales comparison, income capitalization, and cost—may be appropriate, it may be difficult to gather reliable information for all approaches. Each method has its own limitations.

Sales Comparison Approach

Of course, if there is sufficient reliable information, the sales comparison approach will be helpful. Sales of school properties may have unusual complications and are not typical arm's-length transactions. Adjustments for conditions of sale, functional utility, and the need for renovations can be a challenge.

In properties that are conversions of other property types, good practice dictates evaluating the property both as a school and at their alternative highest and best use. For example, an office building that is being considered for school use should be considered both as is and as improved. If the charter school demand is especially weak, the value of the property converted back to a market use should be considered.

Income Capitalization Approach

More-established schools own and operate their own facility. For purchases of existing school properties or for financing purposes of operating schools, the income capitalization approach is also likely to be helpful. Appraisers should understand, however, that

most charter school financing is based on income to the school operation enterprises and not specifically to the real estate. Lenders or investors will be more concerned with the durability and stability of income to the charter school operations rather than real estate income to the real estate.

We have previously discussed market comparables. Expenses are also available from a market analysis. The capitalization rates should take into account the various forms of risk,³² and the possibility of alternate uses of the property in the event of charter school changes. Charter renewal risk is always a concern for school administrators. A school faces the risk of having its charter revoked at the end of the charter term. There can be several reasons for loss of a charter. The school may not meet the performance benchmarks set at the beginning of the enterprise. Management may be unstable. Demographic trends may change.

In addition, capitalization rates might also reflect organizational risk because charter schools generally have a short operating history. Furthermore, there are repayment risks in charter school real estate. For example, if revenues fall because of a failure to meet enrollment projections or changes in demographics, the charter school may go out of business and default on its loan. In the case of a default, collateral risk is a major concern for landlords and lenders.

There is a potential inability to remarket a building that has functioned as a former charter school facility that may impact the ability to liquidate the asset and repay the loan. However, according to a 2005 study by the Kauffman Foundation, the vast majority of facilities are able to be leased or sold to others on terms no less favorable to the lender or landlord when school tenants vacate prematurely. The current rate of reuse on equivalent terms is 95.8%.³³

Cost Approach

In estimating the value of buildings that are specially designed as schools, the cost approach will typically have validity. Current market data on school construction costs and the special designs and uses of the building can be addressed in the cost approach. Appraisers can obtain this data through manuals, conversations with specialized architectural firms that have experience in school construction, public

32. Charter School Facilities, "Section VI: Financing Your Charter School Facility," http://www.uscharterschools.org/gb/dev_fin/financing.htm.

33. Ewing Marion Kauffman Foundation, *Debunking the Real Estate Risk of Charter Schools* (2005), 5.

school administrators who have experience in new building and remodeling, as well as specialized contractors. The limitations in the use of the cost approach to value charter schools are the appraiser's estimates of depreciation and obsolescence.

The valuation of land for a charter school can be complex. Land values in the market usually reflect a different highest and best use. Charter school clients may need a land valuation to consider a development opportunity and see if their use will be competitive with alternative uses. It is good practice to review local land sales with similar zoning and utility. However, in valuing land for a charter school or advising a charter school on site selection, land value is most meaningful when it relates to buildable areas and the utility that a site offers for the specific intended use of the charter school. This may require some basic site planning to see if the land can work for the proposed charter school and analysis of land area based on potential buildable area.

Conclusion

The charter school movement is a dynamic educational phenomenon that will likely become more accepted in a variety of communities, resulting in increased real estate activity in the coming years. By understanding the specific issues and constraints of this special classification of properties, real estate appraisers can provide an important service and contribution to this worthwhile effort.

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