Combining Opportunity Zones in Charter School Financing

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Opportunity Zones
CHARTER SCHOOL PROGRAMS

U.S. Department of Education
Office of Elementary and Secondary Education

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This brief provides an introduction to how charter schools fit into the Opportunity Zone (OZ)[1] environment for all potential charter school investors, regardless of their previous familiarity with charter schools. Specifically, it outlines that there is a natural overlap of populations served by charter schools and OZs, which makes charter schools a good fit for the wider community development OZs are intended to encourage. The brief concludes with an overview of charter school financing for OZ investors.

Charter Schools, Opportunity Zones, and Community Development

OZs were designed to drive capital to low- and moderate-income communities that have historically been overlooked and underserved by mainstream capital markets. Access to additional sources of capital through the OZ incentive will support new projects in these communities, potentially addressing housing, employment, and educational issues. Quality educational options provided by charter schools are a cornerstone of the greater community and economic development agenda in underserved communities.

Charter Schools and Opportunity Zones Serve Overlapping Populations

Charter schools have significant market share in major cities, particularly in neighborhoods characterized by higher levels of economic distress. On average they serve a higher percentage of students from low-income families and a larger percentage of Black and Hispanic students compared to other public schools. Conditions for the selection of OZ census tracts included high poverty and low income. As a result, it is not surprising that a report published by the National Charter School Resource Center (NCSRC) estimates that there are 3,993 charter schools (over 50 percent of all charters) located in or within one mile of an OZ nationwide[2]. Therefore, a disproportionate number of charter schools cluster in and around those 12 percent of U.S. census tracts that qualify as OZs. The locations of these schools follow the distribution of charter schools generally, with 60 percent of them sited in the nine states shown in table 1 on the next page.

NCSRC estimated approximately 25 to 50 percent of charter schools in OZs will be growing and needing a new facility in the next few years. In addition, the U.S. Department of Education published data in 2019 showing that 70 percent of students living in OZs do not have a public charter school option available to them[4]. In summary, the data point to a significant overlap between the population served by charter schools and OZ census tracts. Moreover, there appears to be significant need for new charter school facilities that could benefit from OZ financing.

[1] To locate Opportunity Zone census tracts, visit https://opportunityzones.hud.gov/resources/map.

[2] Medler, A., Beckett, L., Mohr, D., Griffin, J., and Hamadani, A. (2018). Charter School Facilities Financing Sources: Exploring Quality Opportunity Zones and the U.S. Department of Agriculture Rural Development Programs.

Table 1. Charter Schools Located in and Near Opportunity Zones in Selected States

State	Number of Charter Schools in OZs	Number of Charter Schools Within 1 Mile of an OZ
California	250	357
Texas	120	190
Ohio	112	118
New York	101	148
Arizona	97	176
Florida	92	183
Michigan	74	137
Pennsylvania	50	76
Minnesota	40	89

Source: Medler. et al. (2018)[3]

Opportunity Zone Financing for Charter Schools

OZ financing is a possible new source of funding for charter schools and may be used in combination with conventional debt as well as local and federal incentive programs. If the OZ funding involves real estate as Qualified Opportunity Zone Property (QOZP), it must be either newly constructed or substantially improved. Substantial improvement requires that the Qualified Opportunity Fund (QOF) doubles its adjusted basis in the business (excluding land). Two general distinctions of OZ real estate financing structures can be made.

1) **The charter school as third-party tenant**

   To date, only one publicly known charter school transaction involving OZ financing exists (further described in master class module 3). In this transaction, a growing charter school in New York City entered into a lease agreement with the owner of a to-be-constructed, mixed-use property, which was partially funded by a QOF. For the developer and OZ investor, the school was an attractive tenant with a dedicated funding stream and positive externalities for other building tenants and surrounding community. Whether the school received a financial benefit because of the OZ incentive received by the investor is unclear, but the OZ investment did make the transaction possible, ending the school's long search for a quality educational facility.

[3] *Ibid., includes a full list of all states.*

[4] *U.S. Department of Education. (2019, October 10). Secretary of Education Betsy DeVos Announces New Initiative to Support Opening and Expanding Charter Schools in Opportunity Zones.*

2) **The charter school as co-owner/developer of the building**

   In a hypothetical example, a charter school might be in the process of developing a new school facility and reviewing options to fund the transaction. An OZ investor could fund a portion of the total development costs to supplement school equity as well as conventional debt. In this example the QOF would invest in a Qualified Opportunity Zone Business (QOZB), which would own and develop the real estate (the QOZP) and lease it to the school upon completion. Before entering into an agreement with the QOF, the school should review whether the investor's required return built into the lease payments is affordable and how the cost of capital compares to other available funding sources. With an assumed incremental interest rate risk improvement related to the OZ benefit ranging from 2 to 4 percent, it is important to note that an OZ investment will not necessarily result in an improved cost of capital to the school. Because the QOF likely has a 10-year investment horizon at which point it could sell its interest in the QOZB with tax-free gains on the original investment amount, the school should also focus its analysis in particular on this exit event with the goal of balancing the investor's interest to maximize returns and the school's interest in affordable long-term occupancy costs.

Another way to leverage this structure for the school's benefit would be to build on existing relationships with high-net-worth individuals with a track record of supporting charter schools. If such a relationship exists, the individual could utilize capital gains to invest in the school's project through an OZ structure and leverage the OZ benefit to magnify its impact on the school.

If a school is examining whether OZ financing could be a fit for its facility project located in an OZ, the following considerations should be made:

1) Does the project satisfy the original use or substantial improvement requirement?
2) Does the school have relationships with recipients of substantial capital gains? If not, how will the school locate a suitable investor?
3) Is the potential investor familiar with charter schools? If not, will the investor be comfortable with a charter school investment?
4) Is the resulting cost of capital affordable to the school in the long term?

Lastly, the school should consult with experienced professionals, including accountants, attorneys, and financial advisors, both to vet the transaction and to assist with introducing the project to potential investors.

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