Module 3

Charter Schools and Opportunity Zones: Working Together for Community Development

Module Summary

Opportunity Zones

CHARTER SCHOOL PROGRAMS

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

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Impact investing and Opportunity Zone goals

Impact investors are interested in achieving social impact within a community in addition to generating financial returns. There are multiple ways charter schools may meet these impact targets. The primary issue in many low-income census tracts is lack of quality schools, and these tracts often are eligible to be Opportunity Zones (OZs). Therefore, investing in quality public charter schools is one way for an impact investor to address systemic inequality for low-income children by ensuring that they have access to the same educational options as children in higher income areas.

The OZ program shares some of the same goals as impact investors: to stimulate economic development and job creation by investing private capital in economically distressed communities. Recall that OZ investments can be made in businesses and in real estate. Most OZ investments so far have been in real estate and, therefore, the ways jobs are created in the community may not be as obvious. However, OZ real estate investments create construction jobs, and the businesses that operate within OZ-financed real estate will also create and retain jobs. Charter schools in particular can create quality, permanent jobs that serve as an investment in the neighborhood's future. Moreover, evidence suggests that a quality school can have a positive impact on the surrounding communities, including opening of new service businesses and increasing property values[1].

Charter schools in Opportunity Zone deals

Charter schools and other owners or users of real estate should understand that OZ equity funding for real estate projects is one of many available options and should be considered in addition to other financing options the school may be eligible to receive. OZ financing can (i) provide needed equity in the capital stack, potentially from multiple for-profit and/or mission-aligned/impact investors in exchange for property ownership; (ii) allow projects to move forward more quickly; (iii) help strengthen the ability to compete for certain federal, state, and local funding programs and incentives; and (iv) potentially reduce the level of financial loan covenants that a lender may require[2].

[1] See Chung, C. (2002). "Using Public Schools as Community-Development Tools: Strategies for Community-Based Developers." and Joseph, M. and Feldman, J. (2009). "Creating and Sustaining Successful Mixed-Income Communities: Conceptualizing the Role of Schools." Education and Urban Society. 41.6: 623-652.

[2] Loan covenants are conditions of a loan or bond issue, such as minimum operating margins, balance sheet reserves, or liquid cash requirements.

However, OZ financing may be more expensive than some sources of financing in which case an OZ investment may not be an ideal source of funding unless other benefits outweigh the higher costs. OZ investment can be more affordable than some forms of financing, particularly subordinate loans. In addition, OZ financing is subject to certain requirements around the deployment timeline, improvement thresholds, asset deployment thresholds for Qualified Opportunity Funds (QOFs), and ongoing compliance. Schools should weigh these pros and cons before deciding to include OZ investment as part of their facilities financing package.

An example of an existing OZ deal that includes a charter school is the Zeta Charter Schools project in New York City, which was able to happen because of OZ equity[3]. Zeta Charter Schools will be the anchor tenant in the space when it is completed in 2022. Being a tenant in this project means Zeta will not need to manage construction of the building while still being able to secure new, state-of-the-art space. The multiuse development that will surround the school's facility will also help draw students to attend the school and will help with staff attraction and retention. Similarly, the increased foot traffic related to the school will benefit small businesses located in and near the building.

Considerations for charter schools about Opportunity Zone financing

Anyone thinking about including OZ funding in their project or becoming part of an OZ deal, particularly nonprofits like charter schools, should consider the following before making a decision.

- **Location.** Locating the school in an OZ may strengthen the school's ability to compete for federal, state, or local funding, even if the project does not tap OZ financing.
- **Substantial improvement versus original use property.** In general, if the project does not include new construction, a threshold for investment (called substantial improvement) must be met. This generally means a doubling of the building's value through improvements. The final regulations for the OZ incentive provide different methods for reaching that threshold, which allow for flexibility.
- **Lease and sale of the property.** In order to qualify for the OZ benefits, leases must be market rate, and sale of the property must be at fair market value. Charter schools who lease OZ-financed property should strive to negotiate lease rates as aggressively as possible and secure a first right of refusal/option to purchase the building in the future. However, schools should carefully consider whether the cost of the lease is affordable in the immediate term, and whether the cost of a fair market value acquisition will be affordable at the end of the lease term. Given the structure of the program, this is not a guarantee. Local, state, and Tribal governments are exempt from market-rate leasing requirements.
- **Accessing OZ equity.** The charter school will need to locate an individual or organization willing to invest in the project. Charter schools should consider using a QOF manager with the proven ability to handle the transaction and ongoing compliance.

QOFs seek projects that create a community benefit and make sense financially. Charter schools are often viewed by property owners as strong anchor tenants when there is demonstrable demand for the operators' services. A charter school can use that to its advantage and approach partnerships from a position of strength when seeking expansion or relocation of a facility. As with any financial transaction, the school and the OZ investor must come to terms that meet all parties' needs.

[3] *For a more in-depth look at this deal, read the case study included in the module 3 toolkit.*

Charter schools should also weigh OZ funding against traditional funding sources by considering the following.

- What are the all-in costs of OZ funding during the term and at exit? What other requirements does the investor have?
- What other sources of funds can the school access and what are all-in costs? What other requirements does the funder have?
- What possible requirements are there for the OZ and other funding, for example, an equity requirement, required reserves, or compliance requirements?
- Has the funder worked with charter schools or made other educational investments before?
- Combining debt and equity: How might the OZ investment be used to balance lender requirements, e.g., an equity requirement?

Another consideration is whether it would be possible for existing supporters of charter schools to use the OZ incentive to magnify their social impact investing. For this to work, the charter school would have to be an active participant in the OZ transaction and have a relationship with a QOF or a high-net-worth individual. When it does work, the OZ incentive may be a new tool to magnify the impact of mission-driven charter school funding. Since a QOF has ongoing return and exit requirements, there may be a conflict between a profit-motivated investor who wants to receive the highest possible return on exit and the charter school's competing interest to remain in the facility for the long term. In one example, the size of the potential QOF benefit is estimated at between 2 to 4 percent, but that could change significantly depending on the assumed asset appreciation and what assumptions are made about the holding period (10 years maximum for QOFs).

To facilitate OZ investments in charter school facilities, stakeholders should consider educating investors about the benefits and limitations of charter school facility projects and creating a marketplace to bring together OZ investors with charter school projects.

Review Questions

Answer these questions to check your understanding of this module. The section name above a set of questions refers to the section of the videos and the module summary where to find the information.

Impact investing and Opportunity Zone goals

1. What types of goals do impact investors and the Opportunity Zone (OZ) program have in common?

2. How can charter schools help support those goals?

Charter schools in Opportunity Zone deals

3. What are some pros and cons of OZ financing?

4. What was Zeta Charter Schools' role in the OZ deal described? (Select one.)

   ☐ Zeta was a tenant of the OZ-financed property

   ☐ Zeta secured investors for the property

   ☐ Zeta owned the OZ-financed property

Considerations for charter schools about Opportunity Zone financing

5. What are the four areas for charter schools to consider about OZ financing?

6. What are some questions charter schools can ask when comparing OZ funding to traditional funding sources?

7. How could existing charter school supporters use the OZ incentive to magnify their impact investing?

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