Module 3

Charter Schools and Opportunity Zones: Working Together for Community Development

Toolkit

Opportunity Zones
CHARTER SCHOOL PROGRAMS

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

Module 3:

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CONTENTS

Real-World Case Study: Zeta Charter Schools[1]

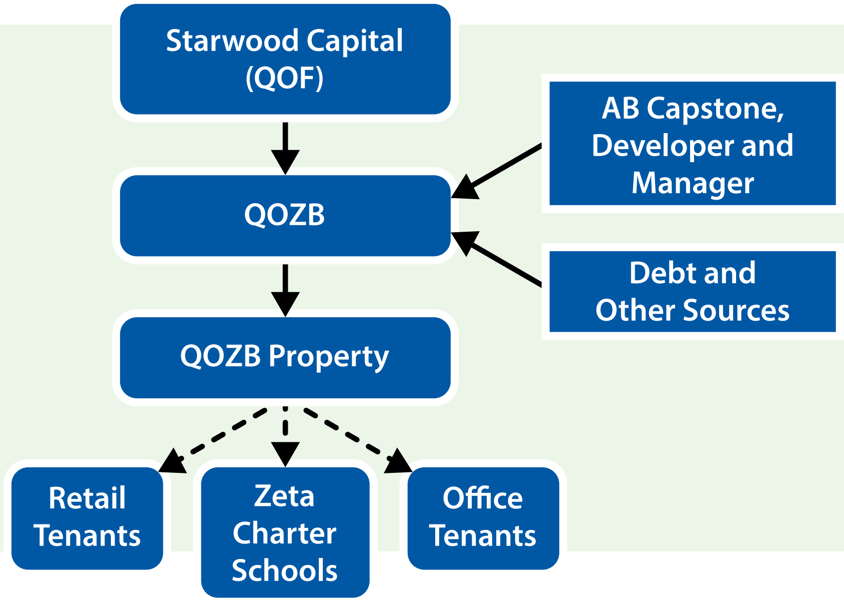
Background

Two years after the Tax Cuts and Jobs Act of 2017 created the Opportunity Zone (OZ) incentive, the first known charter school-related transaction occurred when Zeta Charter Schools signed a lease on a property that was financed in part through an OZ investment. The investment was originated by Starwood Capital, a Qualified Opportunity Fund (QOF), which capitalized a Qualified Opportunity Zone Business (QOZB) affiliated with AB Capstone, a New York developer. Through the transaction structure, the OZ investment was combined with other capital sources to fund the new construction of a ten-story, 147,000 square-foot building located in the Bronx, New York. The building will feature offices and ground-floor retail space with Zeta Charter Schools as the anchor tenant. According to one publicly available report, the total project cost was approximately $75 million funded by a combination of a $51 million construction loan and a $24 million OZ investment.

Zeta Charter Schools, founded in 2017, operates two campuses that served 480 students in Kindergarten through 2nd grade in school year 2019-20. The new building will be home to one of Zeta's elementary schools, which is outgrowing the space it currently leases from a traditional public school, and will allow Zeta to expand and add a new middle school.

[1] This case study is based on publicly available information. In cases where the information was not publicly available, we have hypothesized about certain situations within the transaction.

Figure 1. Hypothetical Transaction Structure for Zeta Charter Schools Project



Transaction Participants and Motivations

In a transaction such as this, there are three primary actors who must come to terms to make the deal happen: the developer-owner of the property, the OZ investor, and the charter school. Over the course of negotiations, these three actors must compromise to reach their goals and close on the transaction. None of the actors is able to reach their goal without the others.

The developer-owner drives the project financing structure. In this case, AB Capstone determined that an OZ investment provided the best value and cost of capital to meet the project requirements. The OZ investor, Starwood Capital, may have been attracted to the project because of the tax benefits of the OZ incentive and/or because of the positive impact the development is planned to have on the local community. Both the developer and investor share a goal of maximizing return while attracting quality tenants.

Zeta Charter Schools was not involved in the financial structure of the project, but came in as a potential tenant. Both the developer-owner and the OZ investor needed to understand the risks of having the charter school as a tenant prior to signing the lease. Similarly, the school needed to assess the potential benefits of leasing the space and negotiate lease terms as it would in any other facilities transaction.

As part of their risk assessment of charter school tenancy, the developer and investor may have reviewed the demand for the school's available seats to ensure that the school would be able to afford lease payments in the future. In addition, they may review the school's authorizer accountability reports, including academic performance, to understand whether risk regarding the school's future charter renewal exists. Lastly, the strength of the local charter school market may affect risk assessment, because it reduces re-tenanting risk. In school year 2019-20, charter schools in the Bronx received 25,323 applications for 9,533 available seats, which indicates high demand.

A school that performs well academically along with a strong local charter school market may demonstrate to developers and investors that a charter school will be a reliable tenant.

Ultimately, the developer was convinced that Zeta Charter Schools was the best option for a quality anchor tenant for the project, and Zeta was comfortable with the financial terms of the lease. On the school's side, it benefited from the project by having access to state-of-the-art new space that may not have been built without the OZ investment. In addition, because the school was able to occupy commercially less desirable space, such as the cellar and rooftop, the lease payments had a lower cost per square foot. All three parties benefit from having a mixed-use building that co-locates services while students and parents of the school increase foot traffic through the entire development.

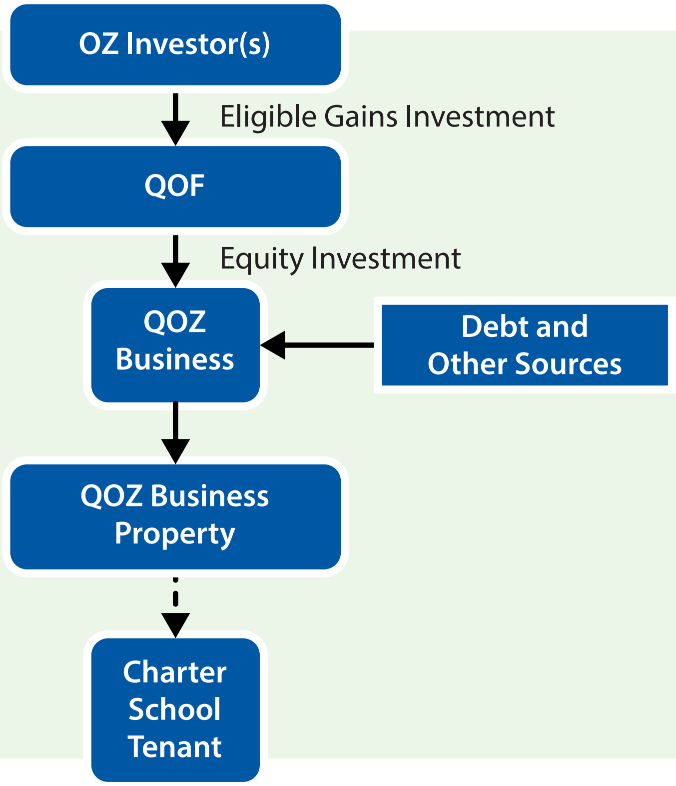
Hypothetical Case Study: Sample Charter School

As described in the Zeta Charter Schools case study, Zeta Charter Schools was a tenant in an Opportunity Zone (OZ) project and as such had limited control over the larger transaction structure. This dynamic could shift if a charter school had control over land and a favorable relationship with a high-net-worth individual. This case study hypothesizes such a charter school project that pursues OZ funds for facility costs. Following the case study, we describe a few variations on the types of charter school-OZ deals that could occur.

Background

Sample Charter School (SCS) has outgrown its current elementary school facility and needs to expand. After comparing lease and ownership options for new space, the school decided to hire third parties to build a new facility. The school fundraised to support the construction budget and secure the long-term affordability of the investment. During the fundraising stage, SCS approached an existing donor to the school, Ms. Doe, about investing in the project. SCS knew its new facility would be located in an OZ; fortunately, Ms. Doe had learned about the OZ incentive and was willing to use her substantial capital gains to support the school, thereby magnifying the social impact of her investment.

Figure 2. Hypothetical Transaction Structure for a Charter School Project Using OZ Financing



Transaction Structure

Ms. Doe had sufficient capital gains to fully capitalize the Qualified Opportunity Fund (QOF). She contributed $5 million, which was combined with a $15 million construction loan to fund the project. The OZ investment had a required preferred return of 1 percent per year for 10 years. In other words, the lease between the Qualified Opportunity Zone Business (QOZB) and SCS was structured so that it generates a profit of at least $50,000 per year (1 percent of $5 million). Assuming lease income of $1.25 million, the QOZB would pay its expenses and debt obligations first and distribute the profits according to the agreed-upon terms. Note that the QOZB cannot enter a triple net lease[2], but instead must be engaged in an "active conduct of business," which here means that the operating expenses include services such as property maintenance, in addition to real estate holding expenses.

Investor Exit

The next piece that had to be discussed was the investor exit. The OZ regulations incentivize the investor to hold the investment for 10 years, but after that the investor can sell their interest in the QOZB and take the appreciated gain on the investment tax-free. To maximize the sales price, Ms. Doe is motivated to achieve the highest-possible lease payment at that time. However, SCS's goal is to occupy an affordable facility long-term. These conflicting interests required the school to conduct additional analysis prior to finalizing the deal.

SCS knew Ms. Doe agreed to a fixed percentage appreciation upon sale of 3 percent at the end of the tenth investment year. In other words, the required exit payment to Ms. Doe would be $6,719,582 (i.e., the initial $5 million investment compounded at the annual appreciation rate for 10 years).

Before entering into the transaction, the school wanted to ensure that it would have the ability to acquire the QOF's interest in the QOZB at exit, since the deal included an option agreement for the school to purchase Ms. Doe's interest in the QOZB at that time. SCS worked with financial advisors to understand the implications of the investor exit and whether the structure was feasible for the school. Using future income and expense projections, they explored whether repaying Ms. Doe (and refinancing the construction loan at that time) would require taking on additional debt or would require engaging in another fundraising campaign to raise sufficient capital. For SCS, it seemed likely that both would be needed, and they began planning early to ensure they would be on track for the investor exit.

Investor and School Benefits

Based on the terms of the transaction, Ms. Doe expects an incremental benefit of 1.71 percent compared to the after-tax internal rate of return (IRR) in a non-OZ investment. This calculation is based on a basic IRR schedule and only accounts for OZ tax benefits[3]. Ms. Doe also considers part of her return to be the expansion of the school and the positive impact improved education has on the community.

SCS sees the following benefits from including OZ investing in its project:

- gaining space for its program and potential growth through new facilities,
- securing affordable lease terms, and
- structuring an investor exit to ensure long-term affordability for the school.

[2] *A triple net lease is a lease agreement on a property whereby the tenant or lessee promises to pay all the expenses of the property including real estate taxes, building insurance, and maintenance.*

[3] *This example assumes that the school and the investor agree to a fixed annual appreciation of 3 percent. If this percentage increased to 7 percent or 15 percent, the incremental benefit would increase to 2.87 percent or 4.52 percent, respectively.*

Variations

The following are possible variations on hypothetical charter school-OZ deals.

1. School-aligned investors looking for a higher return on investment could structure their investment such that the required gain on exit is tied to a percentage of per pupil revenues (PPR). For instance, SCS and Ms. Doe may agree that occupancy costs equal to 10 percent of PPR are a sustainable measure of affordability. Using available take-out financing costs, for instance through tax-exempt bonds, as the numerator and occupancy costs as the denominator, the potential difference between that number and 10 percent would be the basis of the investor's return calculation.
2. Ms. Doe may not be willing to put up the entire investment needed to support the project, but could be willing to invest a smaller amount of seed capital to help SCS raise additional capital, for example $1 million of seed capital to help raise $4 million of additional investments. In such a case, some additional investors may be purely profit motivated while others may accept below-market-rate returns. Ms. Doe could be willing to accept no or subordinate returns, which would change the risk-return relationship for a purely profit-driven investor.
3. Ms. Doe may see how an OZ structure would support SCS's growth, but not wish to be the OZ investor herself. In addition to traditional ways of giving to charter schools, a benefactor could credit enhance an OZ investment by providing a guarantee to another investor for a minimum return upon sale of the QOZB. Providing such a downside guarantee would lessen the risk for the investor and presumably serve to lower the required return.

Conclusion

- There are ways that charter schools could access OZ financing as part of facility projects led by the charter schools.
- The OZ benefit is not always sufficient to incentivize an otherwise poor investment. The benefit does, however, enhance ready investments within sectors familiar to the investor.
- Charter schools should consider accessing their existing networks of significant donors and exploring whether those donors might be willing to participate in OZ structures in one or more of the ways described above.
- It is important to educate investors about the charter school industry to accurately demonstrate the risks and benefits associated with charter school investments.
- While a charter school does not need to understand all the nuances of OZs, actively driving an OZ transaction will require that the school and its development team become experts and access consultants as needed.

Charter Schools as Opportunity Zone Project Participants

Developer Worksheet

Potential or current developers of property within an Opportunity Zone (OZ) can use this worksheet to help identify whether a charter school may be a suitable tenant for a development project.

Much of the information needed to complete this worksheet will be available online, either through web searches or on local school district, charter authorizer, or local government websites. Other information could be obtained by contacting the school district, chamber of commerce, commercial realtors, or other people with knowledge of the local area.

Step 1: Review the current charter school market and local demographics.

1. Are there charter schools currently located within the OZ? ☐ Yes ☐ No
2. Are there charter schools located nearby the OZ? ☐ Yes ☐ No
3. Are the existing charter schools at capacity or oversubscribed, indicating additional demand for new or expanded charter schools? ☐ Yes ☐ No
4. Is the site accessible to school children? ☐ Yes ☐ No

   To answer this question, consider the following:

   4a. What are the demographics of the area? Consider both residents and people who may commute to the area for work.

   ____

   ____

   ____

   4b. Are there a lot of school-age children in the area that could potentially attend the school?
   ☐ Yes ☐ No

   4c. What are the target demographics of the developer or other tenants in the project?

   ____

   ____

   ____

Comments for Step 1

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Step 2: Identify potential lease terms and their fit with charter schools.

1. What lease terms will be offered to tenants based on the cost of capital and are they competitive compared to similar facilities in the area?

   ____

   ____

   ____

2. Will those lease terms be affordable for a school? ☐ Yes ☐ No

   To answer this question, consider the following:

   2a. Do existing charter schools in the area tend to own or lease their space? ☐ Lease ☐ Own

   2b. Are there any charter schools in the area that are in a temporary facility or have outgrown their facility? ☐ Yes ☐ No

   2c. What are average lease terms for similar space in the area?

   ____

   ____

   ____

   2d. How long is the lease term that will be offered?

   ____

   2e. Will the cost of build-out be paid by the developer or the school?

   ☐ Developer ☐ School ☐ Not applicable, no build out needed

3. Do the quality of the school and the local charter school market have appropriate risk profiles? ☐ Yes ☐ No

   To answer this question, consider the following:

   3a. How many charter schools exist in the area? __________

   3b. On average, how long have charter schools in the area been open? __________

   3c. If there is a particular school that may make a good tenant, how long has that school been open?

   ____

   3d. Has the charter for the school(s) gone through a review and/or renewal process in the past? ☐ Yes ☐ No

   3e. Were there any findings of that review? ☐ Yes ☐ No

   3f. If yes, what were the findings?

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Comments for Step 2

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Step 3: Make a determination and move forward.

If the answer to most questions was Yes, then it is more likely that a charter school could be considered as a potential tenant. Once a developer determines that a charter school may make a good tenant, the developer can discuss specific details on tenancy and finances with individual schools to find one that may be a good fit for the project. In addition, consider having a potential charter school tenant complete the charter school companion worksheet so they can also determine if the partnership is right for them.

Determination for Step 3

- ☐ Move forward with securing a charter school tenant.
- ☐ Do not move forward with a charter school tenant.
- ☐ Consider a charter school as a tenant for a future project.
- ☐ Gather additional information.

Comments for Step 3

Charter Schools as Opportunity Zone Project Participants

Charter School Worksheet

Charter school or charter management organization staff should complete this worksheet as they consider whether to locate a new charter school facility in an Opportunity Zone (OZ) and whether OZ financing is a good fit for the school.

Some of the information needed to answer these questions is available online. The U.S. Department of Housing and Urban Development website offers a map of OZs, while local information can be obtained through municipal government or school district websites; by contacting area developers, chamber of commerce, or commercial realtors; or conducting community needs assessment surveys.

Step 1: Research local Opportunity Zone demographics and needs.

1. Is the charter school in need of either a completely new facility or a substantially rehabilitated facility?
   ☐ Yes ☐ No
2. Is the charter school located in an OZ? ☐ Yes ☐ No
3. If the charter school is not located in an OZ, is the school able to relocate to an OZ? ☐ Yes ☐ No

   3a. How close is the nearest OZ to the school?

   ____

4. Are there charter schools currently in the OZ? ☐ Yes ☐ No
5. Are there enough families with school-age children in the OZ to indicate need for a new charter school? ☐ Yes ☐ No
6. What is the charter school's targeted student population?

   ____

   ____

7. Do OZ demographics align with the school's targeted population? ☐ Yes ☐ No

Comments for Step 1

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Step 2: Identify financing needs and opportunities.

1. Does the school prefer to lease or own its facility? ☐ Lease ☐ Own
2. Are there any projects in development in the OZ that the school could enter as a tenant?
   ☐ Yes ☐ No ☐ Not applicable, lease not preferred
3. Has the school accessed financing from entities with substantial capital gains in the past who may also be interested in this opportunity? ☐ Yes ☐ No
4. Has the school accessed financing from philanthropists or impact investors in the past who may also be interested in this opportunity? ☐ Yes ☐ No
5. Is the school already considering a financing package for the new facility? ☐ Yes ☐ No

   5a. Is there a gap in financing that needs to be filled?

   ☐ Yes ☐ No ☐ Not applicable, no current finance package
6. Once an investor is being considered, what is the investor's required rate of return during the 10-year OZ term as well as upon exiting the investment?

   During 10-year term:

   ____

   Upon exit:

   ____

   6a. Is the required rate of return higher than other financing options available? ☐ Yes ☐ No

   6b. Does the potential investor have impact investment goals, where the benefit of the charter school to the OZ community could potentially make up for a lesser rate of return? ☐ Yes ☐ No

Comments for Step 2

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Step 3: Make a determination and move forward.

If the answers to these questions suggest a possible OZ investment, the school should consult with an experienced attorney and consultant to further analyze the possibility. If the majority of the questions are answered Yes, the charter school is more likely to find OZ financing a good fit.

In addition, consider having a potential developer/landlord or investor complete the developer companion worksheet so they can also determine if the partnership is right for them.

Determination for Step 3

☐ Move forward with locating in an OZ without OZ financing.

☐ Move forward with locating in an OZ with OZ financing.

☐ Do not move forward with locating in an OZ.

☐ Gather additional information.

Comments for Step 3

Opportunity Zones

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