Arizona School For The Arts; Charter Schools

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Credit Profile		
ICR		
Long Term Rating	BB+/Stable	New

Rationale

S&P Global Ratings assigned its 'BB+' issuer credit rating (ICR) and stable outlook to Arizona School for the Arts (ASA).

We assessed ASA's enterprise profile as adequate, characterized by its long operating history led by a stable management team, with sound enrollment, healthy retention, robust academics, and a differentiated program focused on interweaving academics and performing arts. We assessed ASA's financial profile as vulnerable, characterized by its high debt burden, somewhat slim 1.17x pro forma maximum annual debt service (MADS) coverage due to reinvestments in the school, and negative unrestricted net assets. In our view, ASA's good liquidity slightly offsets these weaknesses.

We believe that, combined, these credit factors led to an indicative stand-alone credit profile of 'bb+' and final rating of 'BB+'.

The rating reflects our opinion of ASA's:

- Consistent operations since 1995,
- Good cash for the rating with 98 days' cash on hand for fiscal 2018,
- Favorable charter term with a charter renewal in 2011 for 20 years through July 2031, and
- Healthy demand with stable enrollment and excellent academic performance.

We believe somewhat offsetting factors are, what we consider, ASA's:

- Slim, albeit sufficient, pro forma MADS coverage of 1.17x based on fiscal 2018 results;
- High debt burden and negative unrestricted net assets;
- Limited enrollment growth potential due to it being near the stated capacity; and
- Inherent risk, as with all charter schools, the charter authorizer could close it for nonperformance of its charter or financial distress before the bonds' final maturity.

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 provisions; bankruptcy standing; or liquidation, statutory preferences, or legality and enforceability.

ASA has two bond series outstanding: series 2008 education revenue bonds, with $10.16 million outstanding, and series 2011 education revenue bonds, with $8.485 million outstanding. These issuances financed the acquisition, expansion, and renovation of school buildings. ASA's revenue, as defined in governing bond documents, primarily state per-pupil funding, secures its debt. ASA issued $10.9 million of new debt, in the form of a loan from the Equitable School Revolving Fund, to advance refund the series 2008 bonds prior to the call date of Nov. 1, 2019. We have taken into account the new debt and refunding bond terms when analyzing ASA's debt profile.

ASA began operations in 1995 in downtown Phoenix with 175 students. ASA currently serves 852 fifth- through 12-grade students from 106 Maricopa County zip codes. The single-site charter school is a 501(c)(3) nonprofit organization. ASA specializes in interweaving academics and performing arts and features, at least, two hours of daily artistic study--including music, theater, or ballet--and formal academic student projects, culminating in a presentation to parents and staff; we view this as a favorable niche in a highly competitive market.

Outlook

The stable outlook reflects S&P Global Ratings' opinion that during the next year, ASA will likely maintain a steady financial profile. While we view reinvestment in the school as supporting its market position, we expect ASA will likely continue to generate positive operations, improve MADS coverage, and maintain stable liquidity. We expect ASA's demand profile will likely continue to reflect excellent retention, robust academics, and stable enrollment.

Downside scenario

We could lower the rating if MADS coverage were to decrease, cash were to decrease materially, or ASA were to issue additional debt beyond the proposed issuance. We expect ASA will likely manage expenses and reinvestments in the school such that financial performance remains positive.

Upside scenario

We view a positive rating action as unlikely during the one-year outlook period due to ASA's slim MADS coverage. However, we could raise the rating or revise the outlook to positive with a demonstrated trend of MADS coverage that is more consistent with higher-rated peers while management maintains its sound enrollment-and-demand profile, impressive academic performance, and healthy liquidity.

Enterprise Profile

Economic fundamentals

ASA is in Maricopa County. The county's minor population is very sizable at about 1.4 million; county projections indicate population should increase by 1.7% through 2023, which we view positively.

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, profitability, substitution risk, and growth observed in the industry. We believe the charter-school sector represents a moderately high credit risk compared with other industries and sectors.

Market position

We view ASA's enrollment-and-demand profile as sound, supported by sufficient enrollment and solid retention. Total enrollment has been stable. In fall 2018, student enrollment totaled 852, up slightly from 849 in fall 2017. According to management, the school is operating close to its physical capacity and long-term student enrollment goal of roughly 880 during the next five years. Officials do not currently plan to expand to accommodate higher enrollment. ASA's waitlist, which management purges annually, was 292, or, what we view as, a sufficient 34% of enrollment, for fall 2018.

ASA's impressive academic programs and performing arts niche allow it to maintain an excellent market share, in our view. ASA's test scores are higher than state averages. Although there is ample competition in the Phoenix market, we believe ASA's performing arts focus and high test scores help the school draw students and differentiate it from competitors. We expect no significant changes to the demand profile for the next few years.

We view ASA's standing with the charter authorizer as sound. In 2011, Arizona State Board for Charter Schools renewed ASA's charter until 2031. In 2017, the authorizer cited a couple of minor infractions; however, the overall rating for the school has continually met the operational standard every year. Although ASA immediately corrected the infractions, related to a board member's midterm resignation, the evaluation framework does not yet note it. Management reports it is currently fully compliant with the authorizer.

The statutory framework assessment reflects our opinion that while there could be some areas of risk, the framework is not likely to impair ASA's future ability to pay debt service. State per-pupil funding has been stable with slight increases during the past several years. While state funding has increased by 6% in fiscal 2019, we expect more-modest funding increases during the next few years.

Management and governance

ASA has a full operational-and-financial-management staff, and it does not use an outside management company. ASA's senior management team and board of directors are stable, and we view management as adequately running the school. Management hired a full-time, in-house business director to address operational and financial risks annually.

The 11 board members have various backgrounds, including finance, accounting, legal, education, and nonprofit. ASA operates with four standing committees that include a mix of board members and staff. The board and committees meet regularly and participate in material financial and programmatic decisions that greatly affect the organization. In our view, management actively assesses its long-term goals and applies solutions to meet those goals. In our opinion, ASA manages financial operations acceptably.

Financial Profile

Financial performance

ASA has a history of sustaining positive cash-based operating margins and very-slim-to-negative full-accrual margins, with slim lease-adjusted MADS coverage of about 1.17x in fiscal 2018; this characterizes ASA's financial performance. Management attributes lower operating margins in fiscal 2018 to reinvestment projects with purchases of new Chromebooks and website redevelopment. We expect better operational performance for fiscal 2019.

While this level of coverage reflects limited flexibility, management attributes slim coverage to reinvesting surpluses into operations because liquidity is already healthy. While we view reinvestment as further securing the school's market position, we expect ASA will likely demonstrate expense flexibility should enrollment or funding decrease. We do not expect the organization's operating base will likely grow materially during the next few fiscal years.

Liquidity and financial flexibility

We consider ASA's balance sheet sufficient, providing some flexibility. Liquidity has remained satisfactory. At fiscal year-end 2018, ASA had 98 days' cash on hand, which we consider respectable. Management indicates it does not currently plan to draw down cash. We expect continued positive operating performance to assist in maintaining sufficient liquidity.

Unrestricted reserves for fiscal 2017 were 12% of debt, which we view as thin for the rating. Unrestricted net assets were a negative 5% of expenditures, a slight improvement during the past several fiscal years; we expect this trend will likely continue in fiscal 2019.

Debt burden

ASA has about $18.645 million of debt with annual lease-adjusted debt service of roughly $1.76 million. With the proposed new issuance, debt should increase to $19.385 million. Pro forma lease-adjusted MADS should also decrease to $1.608 million. This translates to high debt burden of about 18%. ASA does not have any additional contingent liabilities or off-balance-sheet debt. While we view debt as high for the rating, ASA does not currently plan to issue additional debt other than proposed debt.

As with many charter schools, the organization's debt-to-capitalization ratio shows significant debt on its balance sheet. For fiscal 2018, the ratio was 102%, which we consider high compared with negative unrestricted net assets. We view ASA's debt as a credit weakness.

Financial policies

ASA has formal investment-allocation, liquidity, and debt policies. ASA meets standard annual disclosure requirements. The financial policies assessment reflects our opinion that while there could be some areas of risk, the organization's overall financial policies are not likely to impair 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, contingent liabilities, and legal structure; we compare these policies with comparable providers.

Arizona School for the Arts Select Enterprise And Financial Statistics

	--Fiscal year-end June 30--					Medians for 'BB+' rated charter schools
	2019p	2018	2017	2016	2015	2017
Enrollment						
Total headcount	852	849	852	843	840	1,056
Total waitlist	292	281	279	263	N.A.	MNR
Waitlist as % of enrollment	34.3	33.1	32.7	31.2	N.A.	18.5
Financial performance						
Total revenue ($000s)	N.A.	8,448	8,114	7,905	7,158	11,497

Arizona School for the Arts Select Enterprise And Financial Statistics (cont.)

	--Fiscal year-end June 30--					Medians for 'BB+' rated charter schools
	2019p	2018	2017	2016	2015	2017
Total expenses ($000s)	N.A.	8,525	8,010	7,704	7,262	MNR
EBIDA ($000s)	N.A.	1,761	1,960	2,064	1,787	MNR
EBIDA margin (%)	N.A.	20.8	24.2	26.1	25.0	15.9
Excess revenue over expenses ($000s)	N.A.	(77)	104	201	(104)	MNR
Excess income margin (%)	N.A.	(0.9)	1.3	2.5	(1.5)	3.8
Operating lease expense	N.A.	30	6	6	6	MNR
Lease-adjusted annual debt service coverage (x)	N.A.	1.11	1.23	1.43	1.03	MNR
Lease-adjusted annual debt service burden (% of total revenue)	N.A.	19.2	19.8	18.3	24.4	MNR
Lease-adjusted annual debt service burden (% of total expenses)	N.A.	19.0	20.0	18.7	24.1	MNR
Maximum annual debt service (MADS) ($000s)	N.A.	1,608	1,608	1,608	1,608	1,465
Lease-adjusted MADS coverage (x)	N.A.	1.11	1.22	1.29	1.12	1.40
Lease-adjusted MADS burden (% of total revenue)	N.A.	19.0	19.8	20.3	22.5	13.1
Lease-adjusted MADS burden (% of total expenses)	N.A.	18.9	20.1	20.9	22.1	MNR
Pro forma MADS ($000s)	N.A.	1,534	1,534	1,534	1,534	MNR
Pro forma lease-adjusted MADS coverage (x)	N.A.	1.17	1.28	1.35	1.17	MNR
Pro forma lease-adjusted MADS burden (% of total revenue)	N.A.	18.2	18.9	19.4	21.4	MNR
Pro forma lease-adjusted MADS burden (% of total expenses)	N.A.	18.0	19.2	19.9	21.1	MNR
Total revenue per student ($)	N.A.	9,951	9,524	9,377	8,521	MNR
Balance sheet metrics						
Days' cash on hand	N.A.	98.1	110.6	109.0	93.8	102.5
Total long-term debt ($000s)	N.A.	18,165	18,860	19,070	19,105	MNR
Unrestricted reserves to debt (%)	N.A.	12.0	12.5	11.3	9.1	17.0
Unrestricted net assets as % of expenses	N.A.	(5.3)	(4.6)	(6.2)	(9.8)	24.8
General fund balance ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Debt to capitalization (%)	N.A.	102.4	102.0	102.5	103.6	87.0
Debt per student ($)	N.A.	21,078	21,263	22,372	22,702	15,066
Pro forma metrics						
Pro forma unrestricted reserves ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Pro forma days' cash on hand	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Pro forma long-term debt ($000s)	N.A.	18,905	18,860	19,070	19,105	MNR
Pro forma unrestricted reserves to debt (%)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Pro forma debt to capitalization (%)	N.A.	102.0	102.0	102.0	104.0	MNR

Arizona School for the Arts Select Enterprise And Financial Statistics (cont.)

	--Fiscal year-end June 30--					Medians for 'BB+' rated charter schools
	2019p	2018	2017	2016	2015	2017
Pro forma debt per student ($)	N.A.	22,267	22,136	22,622	22,744	MNR

p--Projected. N.A.--Not available. MNR--Median not reported. Operating lease expense--Annual amount paid in facilities/capital lease payments; excludes equipment/nonfacility lease payments and 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).