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Equitas Academy Charter School Inc., California; Charter Schools

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Equitas Academy Charter School Inc., California; Charter Schools

Credit Profile		
Equitas Academy Charter, Inc. Issuer Credit Rating		
Long Term Rating	BB+/Stable	New

Rating Action

S&P Global Ratings assigned its 'BB+' issuer credit rating (ICR) to Equitas Academy Charter School Inc., Calif. The outlook is stable.

An ICR reflects an obligor's general creditworthiness, focusing on its capacity and willingness to meet financial commitments in a timely manner. It does not apply to any specific financial obligation because it does not take into account the obligation's nature and provision; standing in bankruptcy; or liquidation, statutory preferences, or legality and enforceability.

Equitas is the parent organization of six Equitas Academy schools in Los Angeles. Each school has its own charter. Pico Union Collective (PUC) a non-profit real estate entity formed to acquire property in support of Equitas, issued $33.8 million in series 2018 bonds (not rated), which refunded debt related to the first three Equitas school buildings, and is the legal borrower for the 2020 loan. Equitas is borrowing $31 million from the Equitable Facilities Fund to finance the acquisition of an existing commercial building, and substantial renovations so that it can relocate its fifth and sixth schools, and the network's offices.

All six schools in the network will be obligated for all the debt, and the loan payments will be on par with existing bonds issued under an amended master trust indenture. PUC is the sole member of each of Equitas' member LLCs and serves as the tenant under the various leases. Equitas' existing and proposed debt is secured by a first-lien pledge of rental revenues and mortgages on all related real property. Lease payments are subject to intercept each month by the state controller's office for both the 2018 bonds and the 2020 loan. Following the 2020 transaction, Equitas has about $81 million of pro forma debt.

In response to the COVID-19 pandemic and broader safety concerns, all Equitas schools moved to virtual learning in March 2020, which continued for the remainder of the 2019-2020 school year, as was common among all charter schools across California, and the nation. Equitas provided Chromebooks and HotSpots for internet connectivity, where needed, and continued to provide meals to students and families. Funding of schools in fiscal 2020 continued as expected. For the fiscal 2021 budget, the state of California is deferring about 36% of school aid payable in the months of February-June 2021 until after the fiscal year, but did not cut appropriations relative to fiscal 2020. In compliance with guidelines from state and county health officials, for the 2020-2021 school year, all schools began the year in distance-learning-only mode. Equitas is planning to reopen schools after January 2021, if conditions permit.

In response to the potential impacts of the pandemic, management implemented a wage and hiring freeze in May

2020, but has not cut programs, and opened a sixth school as planned. Expenses incurred due to the outbreak were offset by savings associated with closure of the campuses, such as utilities, and travel and extracurricular activities, in addition to the salary savings from the wage and hiring freeze. In fiscal 2021, Equitas received $400,000 under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. It also anticipates $1.8 million in non-recurring revenues during fiscal 2021 from the Learning Loss Mitigation Fund to support academic programs. In addition, Equitas received $2.5 million of Paycheck Protection Program (PPP) loans under the CARES Act, which it used to pay salaries and benefits, and is eligible for loan forgiveness under current rules. In our opinion, while fiscal 2021 funding deferrals from the state of California, beginning in February 2021 could create a liquidity issue, the above-mentioned relief funds, coupled with the school's good liquidity levels, and a $3 million line of credit should help provide some near-term flexibility.

Credit overview

We assessed Equitas' enterprise profile as adequate, characterized by rapidly expanding enrollment; sufficient demand; healthy retention rates; solid management practices; and a track record of successful replications and charter renewals, including one in November 2020. We assessed Equitas' financial profile as vulnerable, with a history of full-accrual operating surpluses, good pro forma maximum annual debt service (MADS) coverage, decent liquidity, and a very high debt burden. We believe that these combined credit factors lead to an anchor assessment of 'bb'. As our criteria indicate, the final rating can be within one notch of the anchor rating. In our view, the 'BB+' final rating reflects Equitas' healthy enterprise characteristics with a sizable enrollment base, track record of growth, steady market position, and sound governance and management practices.

More specifically, factors supporting the rating include:

- Equitas' rapidly expanding enrollment and revenue base with six schools;
- History of operating surpluses supporting good pro forma MADS coverage for the rating level, with expectations that this will continue;
- Successful renewal of three charters by Los Angeles County Unified School District (LAUSD) during the past three years;
- Conservative financial management practices; and
- Decent cash levels, with fiscal 2021 budgeted to result in about 90 days' cash.

Partially offsetting the above strengths, in our view, are the following credit risks:

- Very high leverage, with debt per student at more than $30,000, which would remain at almost $24,000 assuming all six schools reach full enrollment by 2024, and not factoring in any additional borrowing, and debt to capitalization at 100%;
- Moderate construction risk as Equitas adds a fifth school building in 2021, although we assume enrollment growth could be accommodated as planned over the short term, in the event the project is not completed on time; and
- The inherent risk common to all charter schools that the charters are subject to non-renewal or revocation due to nonperformance of their terms, prior to the maturity date of the bonds and loans.

The stable outlook reflects our expectation that the school's good liquidity position will enable it to manage fiscal stress associated with the state's fiscal 2021 payment deferrals. The outlook also assumes that the school will continue to manage operations and meet financial performance expectations.

Equitas commenced operations in 2009 with its first of six schools, serving grades TK-4, and subsequently opened five other schools serving up to ninth grade, between 2013 and 2020. All of its schools are within one mile of each other, in and around the Pico Union area of Los Angeles. Following its slow-growth model, Equitas generally admits new students in each school, a grade at a time, and only at the K-2, and 5-6 grade levels. Equitas uses leased space to incubate new schools, and seeks permanent leased or owned space over time as the newer schools ramp up. This is the basis of the 2020 project: to provide permanent owned space for EQ 5 and EQ 6. While plans have been paused, Equitas' medium-term goals include adding a seventh and eighth school, and ultimately serving grades 9-12 to provide a consistent learning opportunity for students who currently leave after eighth grade. ExEd is contracted to provide financial, budgeting, accounting, and other services, and is an experienced contractor providing similar service to over 80 schools.

Environmental, social, and governance (ESG) factors

We view the risks posed by COVID-19 to public health and safety as an elevated social risk for the sector under our environmental, social, and governance (ESG) factors, given potential decreases in state funding that could occur as a result of economic pressures and the fact Equitas is highly dependent on state revenues. We believe the school's environmental and governance risk are in line with our view of the sector as a whole.

Stable Outlook

Downside scenario

Although we think Equitas has taken proactive steps to address COVID-19 and understand the coronavirus to be a global risk, we could consider a negative rating action should unforeseen pressures related to the pandemic materially affect the school's demand or finances. We could lower the rating during the outlook period if enrollment growth anticipated in management's forecast does not materialize, or if funding pressures result in weak financial performance and deficit operations.

Upside scenario

A positive rating action is unlikely, in our view, given the pressures of a slow economic recovery and uncertainty presented by the pandemic. In addition, a higher rating would be contingent on Equitas successfully executing its growth plan, increasing enrollment, and moderating its high per-student debt metrics.

Credit Opinion

Enterprise Profile

Economic fundamentals

Equitas operates six schools, all in the Pico-Union, Koreatown, and Westlake areas of Los Angeles. Los Angeles County is is the most populous county in the U.S. The county's minor population is very healthy at about 3 million, although it is projected to decline with a negative growth rate of 5.5% through 2025. Despite the broader decline expected in the county, we believe Equitas has demonstrated the ability to draw and retain students, which offsets falling enrollment.

Industry risk

Industry risk addresses our view of the charter school sector's overall cyclicality and competitive risk and growth through application of various stress scenarios and evaluating barriers to entry, levels and trends of profitability, substitution risk, and growth trends observed in the industry. We believe the charter school sector represents a moderately high credit risk when compared with other industries and sectors.

Market position

Equitas was formed in 2009. The school provides an achievement-oriented learning environment with a college preparatory focus, and its student base consists largely of those that receive free- or reduced-lunch support. Equitas operates on four campuses, and will add a fifth campus to relocate its fifth and sixth schools in 2021, as part of the 2020 financing plan.

With the completion of the expansion of this campus, allowing for additional grade levels, management projects that enrollment will increase to almost 2,800 students by 2024. This figure does not include the addition of two more schools that are part of the strategic plan for buildout, as Equitas is reevaluating the timing of its growth plan, due to the COVID-19 pandemic.

Equitas managed to increase enrollment steadily over the past several years to 1,962 upon opening its sixth school in fall 2020. This figure represents a solid 24.7% increase from the previous year. Equitas anticipates a similar growth rate during the next two years, before tapering off in 2023 and 2024. Retention rates are very high, typically exceeding 90%, and the waitlist rose to 80% of enrollment from 40% during the past few years. However, management reduced the waitlist intentionally in 2020, due to uncertainty over state funding of growth, dropping to just 27%. We expect, given other favorable demand factors, that the waitlist will increase to historical ranges in the future. In total, the school is very near capacity, including temporary spaces, but expects total capacity at all sites will increase to 2,300 by fall 2021. Equitas expects to fill the remaining space in each of its schools via organic growth at existing schools, and longer-term plans include adding two additional schools, and corresponding capacity at new sites, including at the high school level. We note that academic performance at Equitas' schools demonstrates a pattern across all four schools with available statistics of 20%-40% higher ratios of proficient and advanced students compared with the local school district, and slightly above state performance, on average, and trending positively. One exception is Equitas 3, which opened in 2017, which has significantly higher proficiency than both the state and local benchmarks.

Equitas' charter school network has one charter school authorizer for all six of its charters: LACUSD, one of the state's largest authorizers. Despite some inherent tension between school districts that serve as authorizers, we believe recurring charter renewals, including a recent first-time five-year extension for Equitas' fourth school, through fiscal 2026, is indicative of a good authorizer relationship with LAUSD, given its track record of renewals and approval of new charter applications. Equitas' management reported that the relationships with all of the authorizers are favorable. Based on our discussion with the authorizer, LAUSD reports that Equitas is proficient in its governance, which includes structural, financial, and decision-making factors. The authorizer reported no other concerns with academics, financial reporting, and compliance with the charter terms, or state law. The statutory framework assessment reflects our opinion that despite areas of risk, the framework is not likely to hamper the network's future ability to pay debt service, unless state funding is materially impaired and weakens financial metrics.

Management and governance

We believe Equitas' management team is capable, experienced, and approaches its strategic initiatives prudently and conservatively. Equitas has comprehensive policies covering a wide range of financial and operational practices that indicate significant internal controls. We believe the expense controls management adopted at the outset of the pandemic in March 2020, including a wage freeze and a hiring freeze that continued through fiscal 2021, demonstrate Equitas' conservative approach and focus on sound financial performance.

The management, staff, and board of directors include several with close ties to the community of Pico Union, which we believe enhances the school's commitment to serve the students according to the school's mission. We believe the management team is seasoned, with several key personnel having served in multiple roles, which strengthens the organization as a whole. The current CEO is also the founder of the school. Equitas' slow-growth philosophy continues, and allows for deliberate increase of one grade level per year in an individual school site's location. Equitas typically incubates new schools in rented space, and expands to larger space after proving the school has sufficient demand, before entering long-term commitments. The board of directors consists of nine members, with diverse skill sets, and is considering adding a 10th member (the board's maximum size is 13). Board members are limited to two five-year terms.

Financial Profile

Financial performance

In our view, Equitas' financial operations have been solid with healthy margins reported through audited fiscal 2019, which is attributable to rapid enrollment and per-pupil revenue growth. For the fiscal year ended June 30, 2019, Equitas produced an EBIDA margin of 14.5%, or approximately $3.7 million, translating to 1.96x MADS coverage. Although audited figures for fiscal 2020 are not yet available, Equitas anticipates a larger surplus, and pro forma MADS coverage of 1.4x. Equitas' financial performance continues to be boosted by grants from various sources, including Great Public Schools Now ($5.3 million during fiscal years 2017-2019), and the Charter School Growth Fund ($3.25 million during fiscal years 2018-2019). An additional $7.6 million of committed funds is expected during 2020-2023, but Equitas does not anticipate needing additional grants beyond 2023 to fund its operations or expansion. Equitas also received a PPP loan totaling $2.5 million, which is eligible for forgiveness, but has not yet determined if this will be recognized as revenue in fiscal 2021 or fiscal 2022.

Liquidity

Equitas has historically maintained a good liquidity position, although it has fluctuated over the past few years. Unrestricted days' cash on hand, which we consider good for the rating category, totaled 50 in fiscal 2019; this is a decrease from 180 days a year earlier. In fiscal 2020, based on unaudited figures, management expects cash will be boosted to about $10 million, due to a combination of PPP loans and other grants. Management forecasts the cash position will range from about 70 to 90 days over the next four years, which is in line with its informal targets. In addition, Equitas has $3 million of available liquidity through a line of credit with Wells Fargo. Equitas is considering a draw on the line of credit in late fiscal 2021 to bolster its cash position, but otherwise does not intend to draw on the line or borrow from other sources due to the state of California's fiscal 2021 school aid payment deferrals.

Debt and leases

Equitas has about $33.8 million of series 2018 bonds outstanding. It also reports about $16.8 million of New Market Tax Credit debt that will unwind by 2027, with no obligation to Equitas, which we do not factor into our debt ratios. With the proposed 2020 loan, pro forma debt will increase by $30.8 million, to $64.6 million; and pro forma MADS is approximately $4.37 million in fiscal 2042, but is fairly level beginning in 2025. Included in this figure are lease payments for school sites, which we factor into our coverage. This translates to a relatively high debt burden of about 14.6%. The school has no additional contingent liabilities or off-balance-sheet debt. Equitas' debt-to-capitalization ratio continues to show substantial leverage on the school's balance sheet as it continues with its growth plan. For fiscal 2019, the ratio was 90.7%, and the school is almost doubling its debt in fiscal 2021. Management is reevaluating the timing of its growth strategy in the wake of the pandemic, but earlier plans indicated ultimate expansion to a seventh and eighth school, including extending its reach to grades 9-12. Consequently, the financial and enterprise impact of any future expansions is not factored into the current metrics.

Financial policies

Equitas meets standard annual disclosure requirements and maintains standard legal covenants within its debt documents. The financial policies assessment reflects our opinion that, despite areas of risk, the organization's overall financial policies are not likely to hamper its 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 and a comparison of these policies with those of similar providers.

Equitas Academy Charter School, California - Enterprise And Financial Statistics

	--Fiscal year ended June 30--					--Medians for 'BB+' charter schools--
	2021b	**2020u**	**2019**	**2018**	**2017**	**2018**
Enrollment						
Total headcount	1,962	1,573	1,405	1,184	N.A.	1,147
Change in headcount (%)	24.7	12.0	18.7	N.A.	N.A.	MNR
Total waiting list	483	1,236	915	490	516	MNR
Waiting list as % of enrollment	24.6	78.6	65.1	41.4	N.A.	18.5
Student retention rate (%)	97.0	91.0	94.0	94.0	93.0	90.0
Financial performance						
Total revenues ($000s)	N.A.	29,903	25,504	19,234	14,731	13,409
Total expenses ($000s)	N.A.	27,557	26,292	16,396	13,238	MNR
EBIDA ($000s)	N.A.	5,213	3,702	3,276	1,709	MNR
EBIDA margin (%)	N.A.	17.43	14.52	17.03	11.60	14.92

Equitas Academy Charter School, California - Enterprise And Financial Statistics (cont.)

	--Fiscal year ended June 30--					--Medians for 'BB+' charter schools--
	2021b	**2020u**	**2019**	**2018**	**2017**	**2018**
Excess revenues over expenses ($000s)	N.A.	2,346	(788)	2,838	1,493	MNR
Excess income margin (%)	N.A.	7.85	-3.09	14.76	10.14	3.4
Lease adjusted annual debt service coverage (x)	N.A.	1.84	1.45	3.02	1.75	MNR
Lease adjusted annual debt service burden (% total revenues)	N.A.	11.1	15.8	7.3	10.4	MNR
Lease adjusted annual debt service burden (% total expenses)	N.A.	12.1	15.4	8.6	11.6	MNR
MADS ($000s)	N.A.	2,977	2,977	2,977	N.A.	1,686
Lease adjusted MADS coverage (x)	N.A.	2.06	1.96	1.43	N.A.	1.4
Lease adjusted MADS burden (% total revenues)	N.A.	10.0	11.7	15.5	N.A.	13.1
Lease adjusted MADS burden (% total expenses)	N.A.	10.8	11.3	18.2	N.A.	MNR
Pro forma MADS ($000s)	N.A.	4,372	N.A.	N.A.	N.A.	MNR
Pro forma lease adjusted MADS coverage (x)	N.A.	1.40	N.A.	N.A.	N.A.	MNR
Pro forma lease adjusted MADS burden (% total revenues)	N.A.	14.6	N.A.	N.A.	N.A.	MNR
Pro forma lease adjusted MADS burden (% total expenses)	N.A.	15.9	N.A.	N.A.	N.A.	MNR
Total revenue per student ($)	N.A.	19,010	18,152	16,245	N.A.	MNR
Balance sheet metrics						
Unrestricted reserves ($000s)	N.A.	10,811	3,253	7,958	3,430	MNR
Contingent liabilities ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Adjusted unrestricted net assets ($000s)	N.A.	N.A.	8,396	9,185	6,073	MNR
Days' cash on hand	N.A.	149.2	50.0	179.5	96.0	102.00
Total long-term debt ($000s)	N.A.	33,714	33,987	9,658	1,117	MNR
Unrestricted reserves to debt (%)	N.A.	N.A.	34.4	82.4	306.8	16.9
Unrestricted net assets as % of expenses	N.A.	N.A.	35.4	56.8	46.6	24.9
General fund balance ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.	MNR
Debt to capitalization (%)	N.A.	100	85.8	51.3	15.5	86
Debt per student ($)	N.A.	21,433	24,190	8,157	N.A.	15,524
Pro forma metrics						
Pro forma unrestricted reserves ($000s)	N.A.	10,811	17,362	7,958	3,430	MNR
Pro forma days' cash on hand	N.A.	149.15	267.47	179.52	96.02	MNR
Pro forma long-term debt ($000s)	N.A.	64,652	64,925	43,453	1,117	MNR
Pro forma unrestricted reserves to debt (%)	N.A.	13.3	21.3	18.3	307.1	MNR
Pro forma debt to capitalization (%)	N.A.	100	90.67	82.55	15.54	MNR

Equitas Academy Charter School, California - Enterprise And Financial Statistics (cont.)

	--Fiscal year ended June 30--					--Medians for 'BB+' charter schools--
	2021b	**2020u**	**2019**	**2018**	**2017**	**2018**
Pro forma debt per student ($)	N.A.	32,952	34,323	36,700	N.A.	MNR

B--Budgeted. U--Unaudited. N.A.--Not available. N/A--Not applicable. MNR--Median not reported. MADS--Maximum annual debt service. Operating lease expense--Annual amount paid in facilities/capital lease payments; excludes equipment/nonfacility lease payments and excludes payments related to principal and interest on bonds. Net revenue available for debt service = EBIDA + operating lease expense. Lease-adjusted MADS coverage = (net revenue available for debt service + operating lease expense) / (lease-adjusted MADS). Total expenses include pension and OPEB adjustments. Pension and OPEB adjustments = reconciling adjustments made to financial information to account for differences in GASB 68 and GASB 75. Debt per student is net of New Market Credit Bonds.

Related Research

- Criteria Guidance: U.S. Public Finance Charter Schools, Dec. 20, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020