

## CREDIT OPINION

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# YES Prep Public Schools, TX

## Update to credit analysis

### Summary

[YES Prep Public Schools, TX](#) (Baa2, positive) is a large and growing charter school network serving the [Houston](#) (Aa3 stable) metropolitan area. The school has maintained positive operating performance and improved liquidity as it has executed the initial phase of its elementary school expansion strategy. The improved financial position will help provide a cushion against any short term operational disruptions as it continues expanding its elementary school footprint over the next couple of years. The network's low fixed costs burden will provide it with some additional budget flexibility. YES Prep maintains a strong competitive profile demonstrated by solid academic performance, healthy waiting list and student retention metrics. The management team is experienced with sound governance practices and maintains good authorizer performance metrics and a favorable relationship with its authorizer, which indicates very good prospect for another charter renewal coming up in July 2025.

On December 22, 2022, Moody's assigned a Baa2 rating to Yes Prep's \$77.3 million Education Revenue Bonds. The outlook was changed to positive from stable.

### Credit strengths

- » Large scale of operations and long operating track record
- » Highly competitive market position due to solid academics and strong student demand
- » Budget flexibility provided by modest fixed costs

### Credit challenges

- » Potential operational issues due to expansion into previously unserved elementary school market
- » Pending expansion of charter authorization required to fill new facilities

### Rating outlook

The positive outlook reflects an expectation that the network will maintain positive financial performance as it continues to expand its elementary schools, which would support improvement in the rating.

### Factors that could lead to an upgrade

- » Successful implementation of continued elementary school expansion without erosion of operating performance or reserves

- » Reduction in leverage relative to liquidity

## Factors that could lead to a downgrade

- » Decline in operating performance, potentially due to unexpected issues with continued elementary school expansion
- » Increase in debt without commensurate growth in the balance sheet
- » Material decline in state academic or financial accountability scores

## Key indicators

Exhibit 1

YES Prep Public Schools, TX	2018	2019	2020	2021	2022
<b>Scale &amp; Demand</b>					
Total Enrollment	11,480	12,182	12,978	14,341	15,482
Operating Revenue (\$000)	\$144,983	\$154,678	\$183,498	\$201,092	\$228,666
<b>Operating Performance &amp; Liquidity</b>					
Annual Change in Operating Revenues (%)	15.3%	6.7%	18.6%	9.6%	13.7%
Two-year Average Operating Cash Flow Margin (%)	10.0%	9.0%	18.0%	20.0%	16.0%
Total Cash & Investments (\$000)	\$25,017	\$34,382	\$49,169	\$65,117	\$71,789
Monthly Days Cash on Hand	73	94	124	140	131
<b>Leverage &amp; Coverage</b>					
Total Debt (\$000)	\$111,396	\$121,918	\$119,427	\$166,891	\$175,154
Debt Service Coverage (x)	2.4x	2.6x	3.8x	3.3x	2.8x
Spendable Cash & Investments to Debt (%)	22.0%	28.0%	41.0%	39.0%	40.0%
Pro forma Debt (\$000)					\$252,464
Pro forma MADS Coverage (x)					1.8x
Pro forma MADS as % of Operating Revenue (%)					8%
Pro forma Spendable Cash & Investments to Debt (%)					28.0%

Data displayed above is as of fiscal year ending June 30; enrollment for is 2022-23 school year is 16,810

Source: Audited financial statements and Moody's Investors Service

## Profile

YES Prep operates a network of 23 charter schools serving approximately 17,000 students in grades Pre-K to 12 across Houston. YES Prep is operating under its initial charter contract granted in 2000 by the Texas Education Agency, its authorizer. The school's charter contract was renewed for a third time in July 2015 for another 10 year period (extending through July 31, 2025).

YES Prep was founded in 1998 with a focus of delivering a college-ready education to students in the 6th through 12th grades. YES Prep is expanding to serves students in elementary school and opened its first two elementary school in the 2020-21 school year. Currently, YES Prep operates six elementary schools in addition to 17 secondary schools.

## Detailed credit considerations

### Scale and demand: growing charter school network with solid academics

We expect YES Prep's enrollment and student demand to remain strong given its favorable academic performance, sizable waiting list and solid student retention metrics. These characteristics will continue to support management's growth strategy of expanding to serve elementary school students. Since it began its elementary school expansion, enrollment has increased by nearly 30% to 16,810 students in the 2022-23 school year across its 22 campuses, driven largely by opening new elementary schools.

In the 2022-23 school year, at the elementary school level, the waiting list was equal to approximately 30% of enrollment, demonstrating solid student demand at the elementary school level. Across the entire school, a total of 6,344 students, equivalent

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to 38% of enrollment in the 2022-23 school year, were on the waiting list. Management has been strategic about opening new elementary schools by initially serving grades Pre-K to 2nd in the first year and then filling additional grades each year thereafter. YES Prep does not plan to open any new elementary schools this year, but will continue to fill grades at the elementary schools that recently opened. The first two elementary schools opened in the 2020-21 school year and these school will be adding fifth grade next year becoming the network's first two full elementary schools serving students in the Pre-K to 5th grades. YES Prep is planning to open three additional elementary schools from the proceeds of the Series 2023 bonds; these are expected to open in August 2024. Given the network's strong student demand and experience gained from opening six elementary schools, we expect the network will be successful in opening three additional elementary schools and achieving its enrollment target over the next few years.

YES Prep's strong academic performance and focus on college-readiness will support continued enrollment growth. YES Prep achieved an "B" academic accountability rating from the Texas Education Agency in 2022. Many of YES Prep's high school's are recognized by U.S. News & World Report as being some of the best not only in the Houston metro area but also the nation. Ninety-nine percent of the network's 2022 graduating class was accepted to college, demonstrating the success of YES Prep's college-readiness academic focus. Additionally, student SAT and ACT scores are similar to the state, which is significant when considering nearly 90% of students are classified as economically disadvantaged compared to 60% for the state.

#### **Operating performance and liquidity: healthy operating performance boosts liquidity**

We expect that YES Prep's sound operating performance will continue given prudent budget management, however uncertainties around its elementary school expansion poses some risks. Operating cash flow relative to revenue was sound at 14% in fiscal 2022 and the two year average was 18%. Increases in transportation, janitorial and other professional services will place some pressures on margins, but we expect it will be manageable given the network's strong operating revenue growth, averaging 14% over the last three years. The school was awarded a total of \$72 million in ESSER funds and has \$56 million remaining to spend over the next two fiscal years. The network's philosophy on spending ESSER funds has been to use these funds for one-time expenses, helping to eliminate future budget challenges when ESSER funds are no longer available.

YES Prep's revenues are primarily derived from state per-pupil formula funding. State Foundation School Program Act funding comprised nearly 80% of the organization's fiscal 2022 operating revenue. The remainder was primarily derived from a blend of philanthropic and grant contributions, program service fees, and federal revenue. Management reports strong support from both national and local philanthropic organizations and expects contribution revenue to continue. Favorably, the school's policy is to use philanthropic grants for capital and if certain economic events were to put pressure on grant funding, the school would slow its capital spending. Texas increased per-pupil funding for fiscal 2023 and we expect funding levels will likely be maintained given the state's solid finances due to strong revenue collections over the last year.

#### **Liquidity**

The network closed fiscal 2022 with \$71 million in cash and investments, equivalent to 131 days cash on hand, providing the school with a sound cushion to absorb any unforeseen increase in expenses or declines in revenue. At this time, the school does not have any plans to spend down its cash position from the current level.

#### **Leverage and coverage: healthy coverage with current enrollment; elevated debt to liquidity**

We expect debt service coverage to remain sound because of prudent financial management and continued revenue growth. Fiscal 2022 operating cash flow of \$33 million (inclusive of temporarily restricted state funding) provided ample 2.8x coverage of fiscal 2022's \$12 million debt service requirement. Coverage of maximum annual debt service, inclusive of the Series 2023 bonds, is 1.8x demonstrating the network can pay debt service on current revenues considering that it is financing facilities that have yet to come online.

Fiscal 2022 spendable cash to pro forma debt is somewhat low at only 28%, which is elevated for the rating category. The organization intends to continue issuing debt over the long term as it continues to expand within the Houston area, though growth in ongoing operations relative to its financing of continued growth is expected to result in a stabilization of debt metrics. The size and timing of future debt issuances is dependent upon fundraising, as the school is committed to paying at least 20% of any growth costs using fundraised cash in order to maintain healthy debt levels and officials plan to slow expansion should grant revenue decline.

The network's low fixed costs (combined debt service and pension contributions) of 8% of fiscal 2022 operating revenue will provide budget flexibility. Aggregate MADS as a percent of fiscal 2022 operating revenue is also modest at 8%.

#### Legal security

The school's outstanding bonds are secured by pledged revenues, which are defined as all revenues and income received by YES Prep from the operation of its charter schools. The bonds are further secured by a deed of trust covering all but four of YES Prep's campus properties. The real estate collateral has not recently been appraised.

Covenants associated with the organization's debt require that the network maintain 1.2x debt service coverage in each fiscal year.

The organization is required to maintain liquidity equal to 20% of outstanding debt, inclusive of bond sinking funds. An additional bonds test 1.1x MADS, inclusive of the proposed debt, based on the most recently completed fiscal year.

#### Debt structure

Following the proposed sale, the school will have \$252 million in debt outstanding. All of the charter network's debt is fixed rate and amortizes over the long term, though management does have access to one short term line of credit until April 2025 for interim financing or operating cash flow needs. Projected debt service escalates to \$18 million in 2024 (compared to a \$12 million debt service requirement in fiscal 2022) and debt service extends to 2052. Amortization is rapid for a charter school with nearly 50% of outstanding debt scheduled to be retired within 10 years driven by the use of the school's sinking fund deposits to redeem outstanding QSCB and QZABs.

#### Debt-related derivatives

The school does not currently have any debt-related derivatives.

#### Pensions and OPEB

Texas law requires charter schools to participate in the Teacher Retirement System of Texas (TRS), a multiple-employer plan administered by the state. Moody's adjusted net pension liability (ANPL) for YES Prep, calculated under our methodology for adjusting reported pension data, was \$121 million. This represents a manageable 53% of fiscal 2022 operating revenue. Budgetary pressure related to participation in the plan is expected to remain minimal for the foreseeable future. The school's \$5 million fiscal 2022 pension contribution represented a low 2% of operating revenue and this contribution level was 130% of the Moody's determined "tread water" contribution level - this indicates unfunded liabilities will continue to rise using reported assumptions.

#### Charter renewal risk and government relations:

YES Prep operates under a charter granted by the Texas Education Agency. Its first campus was authorized in 2000 and charter extensions occurred in 2005 and 2015. The 2015 extension expires in 2025. All of the schools operate under a combined charter, though authorization is required for expansion. Texas is supportive of its charter schools and has a well-developed set of policies, processes, and practices for overseeing charters. Monitoring of financial health and academic performance is continual.

YES Prep's most recent academic accountability rating was "B (87)" and its financial rating was "A - Superior", indicating strong prospects for continued renewal.

### ESG considerations

#### Environmental

YES Prep serves students in the greater Houston metro area, which is prone to hurricanes and severe thunderstorms. The schools have weathered recent extreme events such as Hurricane Harvey with minimal financial or operational impact, which suggests that environmental events are unlikely to have a material impact on the network in future.

#### Social

The school's academic performance relative to the competing local school district is very strong. The socioeconomic background of its students is primarily low income, though this is not uncommon for charter schools.

#### Governance

Governance for the charter school network is strong overall, broadly in line with other large charter school organizations that operate within Texas. As with all charters, the authorization to operate is subject to periodic approval by the authorizer (State of Texas). The

school has a strong record of charter renewal and high performance in the metrics assessed by the state when considering granting or renewing charter authorization. The network is governed by a 15 member board and day to day operations are overseen by a professional staff of administrators.

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