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California School Finance Authority MPM Sherman Way LLC; Charter Schools

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Credit Profile

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California Sch Fin Auth (MPM Sherman Way LLC) educl facs rev bnds (taxable) (MPM Sherman Way LLC) (Magnolia Science Academy #1 Proj) ser 2014B

Long Term Rating

BB/Positive

Rating Assigned

California Sch Fin Auth (MPM Sherman Way LLC) educl facs rev bnds (MPM Sherman Way LLC) (Magnolia Science Academy #1 Proj) ser 2014A due 07/01/2043

Long Term Rating

BB/Positive

Rating Assigned

Rationale

Standard & Poor's Ratings Services assigned its 'BB' long-term rating to the California School Finance Authority's \$6.06 million series 2014A and taxable series 2014B school facility revenue bonds issued on behalf of MPM Sherman Way LLC for the Magnolia Science Academy-1 (MSA-1), Reseda Project. The outlook is positive.

Bonds proceeds will be secured by MSA-1 revenues with state payments intercepted each month by the trustee to pay debt service on the bonds. The rating analysis encompasses MSA-1 and Magnolia Educational and Research Foundation (MERF), a charter school management organization that founded and operates MSA-1.

The 'BB' rating is based on our view of MERF's group credit profile and MSA-1's highly strategic status to MERF. Although MSA-1's stand-alone credit profile (SACP) is one notch higher than that of the group credit profile we assigned to MERF, the long-term bond rating is capped at 'BB' to reflect the risk that the group could draw support from MSA-1. The rating only applies to this transaction and does not apply to MERF.

The positive outlook reflects the improvement of MERF's operations and financial resources based on one year of audited data and fiscal 2014 projections supported by nine months of unaudited financial reports, which we expect to be realized in the fiscal 2014 audit.

The 'BB' rating reflects MERF's overall enterprise strength with growing enrollment, good academic performance, and stable management. The rating also reflects the variability of MERF's financial operations during the past few years, specifically a deficit in 2012, and the liquidity risk associated with MERF's low cash position relative to its size in fiscal 2011 and 2013 with just \$387,000 (7 days' cash on hand) and \$1.17 million (27 days' cash on hand), respectively. As of March 31, 2014, the end of the third quarter of fiscal 2014, MERF had increased its cash to \$5 million through loan payoffs, a reduction in state deferrals, and improved operations. MERF returned to positive operating performance in fiscal year 2013. It projects positive operations will continue in fiscal 2014 based on its results as of the first nine months of the fiscal year. MSA-1 also had low levels of liquidity with just \$146,000 in unrestricted cash and equivalents available as of June 30, 2013, but as of March 31, 2014, MSA-1's cash position had increased to \$1.26 million due to

the payoff by MERF to MSA-1 of a \$1.17 million intercompany receivable in October 2013.

More specifically, MERF's group credit profile rating reflects our opinion of the following credit risks:

- Low and historically varying levels of cash on hand relative to its size and short-term debt outstanding with seven, 71 days, and 27 days' cash on hand for fiscal 2011, fiscal 2012, and fiscal 2013, respectively, although it had grown to 94 days as of March 31, 2014;
- Varying financial operating performance, with a deficit in fiscal 2012 but a surplus in fiscal 2013 and projected for fiscal 2014; and
- The potential that MERF's various charters could be revoked or not renewed due to MERF's noncompliance with the terms of the charter (as with all charter schools) prior to the bonds' final maturity.

MERF's profile is supported by our view of its:

- Good operations in fiscal 2013 with sufficient cash flow to cover lease-adjusted pro forma maximum annual debt service (MADS) by 2.5x in fiscal 2013;
- Improved state funding environment with a reduction of state deferrals to one month and increased per pupil funding;
- Diverse revenue base as demonstrated by its ownership and operation of 11 charter schools in different areas of California;
- Long total organization tenure dating back to 1997; and
- Good demand, as demonstrated by enrollment increases during the past several years.

Bond proceeds will finance the purchase and renovation of the building currently occupied by Magnolia Science Academy 1 (MSA-1), a charter school in Reseda, Calif., that serves grades six through 12. The bonds are secured by gross revenues of MSA-1, the school with state payments intercepted each month by the trustee. Bonds proceeds will be loaned to the borrower, MPM Sherman Way LLC, a limited liability company, the sole member of which is Magnolia Properties Management Inc. (MPM). The sole member is a recently formed California nonprofit public benefit corporation formed as a support organization for charter schools formed and controlled by MERF. The borrower is a single-purpose entity with no assets other than the facility. MPM Sherman Way LLC will use bond proceeds to acquire the school facility and will lease it to MERF to operate MSA-1. A fully funded debt service reserve fund and a deed on MSA-1's property provide additional security. Upon completion of the plan of finance, MSA-1's pro forma debt will include just the series 2014 bonds.

Outlook

The positive outlook reflects our view that MERF's good projected liquidity, reflecting at least 60 days' cash on hand; operating performance; and debt service coverage for fiscal 2014 is in line with fiscal 2013. The outlook also reflects our expectation that no new debt will be issued, and that MERF will maintain the current strength in demand at its schools and good academic profile.

We would revise the outlook to stable should MERF's fiscal 2014 audit indicate that liquidity and operations continue to remain variable and fall short of expectations. We would consider a lower rating or negative outlook if demand projections are missed, days' cash declines below 25, or if debt service coverage falls below 1x.

Enterprise Profile

The school

MSA-1 was formed in 2002 and was the first charter school opened by MERF. The school provides a STEM-focused education, and its student base consists largely of those that receive free- or reduced-lunch support. MSA-1 operates on one campus, which is made up of the main school building and a gym. MSA-1 will continue to lease the gym after the main school building is acquired by the school.

Construction risk will be limited as the project calls for improvements to the building as opposed to new construction. We understand that the school has no other debt plans in the foreseeable future, so we expect the debt burden should decline as revenues grow.

Los Angeles Unified School District is MSA-1's charter authorizer and has renewed the charter twice, with the next renewal in 2017. The charter cap is limited to the 500 student average daily attendance physical capacity of MSA-1's building. LAUSD indicated it has a positive relationship with MSA-1 and did not identify any concerns related to future charter renewal.

MSA-1's demand profile is strong with enrollment at the maximum physical capacity of 500 and a wait list of 328 students in fall 2013. The school had strong academic performance with an average API score of 797 in 2012-2013, which exceeded averages at the district and state level. The school has also received numerous academic awards, including a U.S. News and World Reports Gold Medal for the Best High Schools, where at the time it was ranked 45th in California and 230th nationally among 22,000 high schools nationwide.

MSA-1 has had varying financial performance with a deficit in fiscal 2012 of \$176,000 and a surplus of \$492,000 on a full-accrual basis in fiscal 2013. Management has budgeted for a surplus of \$731,000 for fiscal 2014 based on the four month year-to-date financials. Lease-adjusted pro forma MADS coverage was solid for the school at 1.7x in fiscal 2013 with projections indicating that coverage will continue to remain at or above this level through 2018. MSA-1 also had limited financial flexibility from a days' cash-on-hand perspective. At the close of fiscal 2013, MSA-1 had \$146,000 of unrestricted reserves providing 14 days' cash on hand. In fiscal 2013, MSA-1 had an intercompany receivable balance of \$1.17 million from MERF, which contributed to the limited cash on hand. As of October 2013, this receivable was paid and resulted in an unrestricted cash balance as of Oct. 31, 2013 of \$905,000, which will increase days' cash substantially.

MERF organizational overview

MERF is a charter management organization founded in 1997. It oversees 11 charter schools in California. Nine of them are located in the greater Los Angeles area with one each in San Diego and Santa Clara. All of MERF's schools have a niche focus that emphasizes science, technology, engineering, and math (STEM). Headquartered in Westminster, Calif., MERF oversees each school's compliance with charter agreements. While each school has its own separate charter, each school's personnel are employees of MERF, and MERF manages all business operations at each of the schools. Management represents that the charters are in good standing with their respective authorizers. Each school has had its charter extended once, with four coming up for their second renewal in 2014 and 2015..

Enrollment and market position

MERF has a well-diversified enrollment base with each school representing no more than 15% of total enrollment. Although in 2012 MERF did close one of its Northern California charters, Magnolia Pacific Technology School in Orangevale, as a result of the inability of MERF to locate adequate facilities, total enrollment continued to grow to 3,935 in fall of 2013 from 3,645 in fall 2012. Management reports that the growing enrollment is supported by the popularity of its STEM focus and its solid test scores at schools with 2013 APIs ranging from 749 to 904.

Management and governance

MERF's executives, including the CEO, CFO, chief operating officer, and chief academic officer, execute the decisions and policies set by MERF's board of directors and manage the business operations of MERF's schools, with individual school principals carrying out site-level operations. Management has formal processes in place for accounting and financial management at the corporate and school level. The centralized overhead functions, such as finance and human resources, provide for some economies of scale.

All 11 schools are governed by a single board with six members. The schools themselves do not have individual boards. Board members are elected for staggered five-year terms. The members have good experience, with most having professional experience in science and technology. The board is active with MERF and is responsible for establishing policies that influence all elements of each school's operations. Each school has a five-member school site council, an advisory body that advocates and communicates to MERF and the board on behalf of the school.

Financial Profile

State funding environment

Prior to the enactment of the state's 2013-2014 budget, charter schools were funded through general purpose entitlement block grants and categorical block grants. On July 1, Gov. Jerry Brown signed into law the Local Control Funding Formula (LCFF). Local educational agencies will receive funding based on the demographic profile of the students they serve. The LCFF creates three funding mechanisms: a base grant for all students, supplemental grants equal to 25% of the base grants for each English learning, economically disadvantaged and foster youth enrollment in excess of 55% of total enrollment, and supplemental grants equal to 50% of the base grant provided for each student above the 55% threshold. Funding under the new formula began in fiscal 2013-2014. Although it is estimated by the state that full implementation will not be complete until 2020, the funding outlook for MERF will be positive given its high portion of economically disadvantaged students. In addition, state deferrals have diminished to around one month, allowing MERF to regrow its cash balances and balance sheets.

Operations

MERF had positive operations on a full-accrual basis in fiscal years 2013, 2011, and 2010, but experienced a deficit of \$797,000 in fiscal 2012. Management indicated that this deficit was primarily caused by state deferrals that were lessened in fiscal 2013, and it projects further surpluses in fiscal 2014. According to Standard & Poor's calculations, which incorporate the existing debt and leases, the full pro forma MADS coverage rose to greater than 2.5x for fiscal 2013 from 0.5x in fiscal 2012.

Balance sheet

MERF has had three years of varied liquidity with periods of very limited unrestricted cash on hand in 2011 and 2013. Unrestricted days' cash on hand was 27 in fiscal 2013, 71 in fiscal 2012, and seven in fiscal 2011. As of March 31, 2014, MERF's cash had grown to \$5 million, which we view as providing operational flexibility for the organization to provide resources to its schools, including MSA-1, should it be needed. Management anticipates maintaining these levels through the end of fiscal 2014. Lease-adjusted debt service remains moderate in our view, when including the bonded debt, at 9.8% of expenses as of fiscal 2013.

Legal covenants

We view the legal covenants supporting the transaction as adequate. The borrower is required to maintain a fully funded debt service reserve, as well as a reserve for repair and replacement. According to the documents provided to Standard & Poor's, bondholders are provided a liquidity covenant requiring at least 45 days' cash on hand commencing June 30, 2015 and annually thereafter and an operating covenant requiring annual debt service coverage at a minimum of 1.0x beginning June 30, 2015. Failure to maintain 1.1x debt service results in the engagement of a management consultant but does not constitute a technical default unless coverage falls below 1.0x.

Related Criteria And Research

Related Criteria

- USPF Criteria: Charter Schools, June 14, 2007
- General Criteria: Group Rating Methodology, Nov. 19, 2013

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