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California School Finance Authority MPM Sherman Way LLC; Charter Schools

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Long Term Rating	BB/Stable	Outlook Revised

Rationale

Standard & Poor's Ratings Services revised its outlook to stable from negative and affirmed its 'BB' long-term rating on the California School Finance Authority's series 2014 school facility revenue bonds issued on behalf of MPM Sherman Way LLC for Magnolia Science Academy (MSA-1), Reseda Project. At the same time, Standard and Poor's revised its outlook to stable from negative.

The revision of the outlook to stable and affirmation of the 'BB' rating reflects our view that the risk of charter revocation of Magnolia Education and Research Foundation's (MERF) schools has been greatly reduced given the settlement agreement between MERF and Los Angeles Unified School District (LAUSD), which provided for the renewal of MERF's MSA-6, MSA-7, and MSA-8 charters and the mutual release of both parties and their successors from any and all claims, liabilities, and legal responsibilities of any form that the parties may have, have had, or claim to have, known or unknown. Because of this, it is our view that the other schools authorized by the LAUSD Charter School Division (CSD), including MSA-1 through MSA-5, will be protected from the same claims made against MSA-6, MSA-7, and MSA-8 that led to their nonrenewal.

Revenue from MSA-1 secures the bonds. Based on the criteria released Nov. 19, 2013, the rating analysis encompasses MERF's organization as the larger group, which includes its home office and functions as a charter management organization (CMO) and its 11 schools, including MSA-1. The 'BB' rating is based on our view of MERF's group credit profile (GCP) and our view that the obligated school supporting the series 2014 bonds is "highly strategic" to MERF. Under the group rating methodology, a highly strategic subsidiary is rated one notch lower than the GCP, unless the stand-alone credit profile of the obligated group is equal to, or higher than, the GCP. In that case, the rating is at the same level as the GCP, which is the case for the 2014 bonds. The rating only applies to the series 2014 bonds and does not apply to MERF as an organization. Financial metrics cited in this report (unless otherwise indicated) reflect those of the entire organization.

Other factors supporting the rating include:

- MERF's diverse enrollment and revenues base with 11 schools;
- Improved liquidity equal to 79 days' cash on hand and 114 in fiscal 2014 for MERF and MSA-1, respectively;
- Positive operations on a full-accrual basis over the past two years, leading to very strong debt service coverage for MERF and MSA-1; and
- An improving state funding environment with a reduction in state deferrals to one month and increased per-pupil funding.

The rating also reflects the following credit risks:

- Significant transition within the organization given the recent changes in senior leadership and changes in policies and practices and
- Lease and facility acquisition risk given that a number of MERF's schools are in leases that renew annually.

The series 2014 bond proceeds were used to finance the purchase and renovation of the building occupied by MSA-1. The bonds are secured by gross revenues of MSA-1 with state payments intercepted each month by the trustee. Bonds proceeds were loaned to the borrower, MPM Sherman Way LLC, a limited liability company, the sole member of which is Magnolia Properties Management Inc. (MPM), formed and controlled by MERF.

Management has indicated that it could issue up to $9.1 million in debt over the next year to acquire a permanent facility for its San Diego campus and to acquire a facility adjacent to MSA-1. We believe MERF has capacity at its current rating level to issue this debt given its solid liquidity and coverage levels. However, any substantial amounts of additional debt beyond what is anticipated that causes a substantial decline in liquidity or coverage could pressure the rating.

Outlook

Based on the application of the group rating methodology , the stable outlook reflects our anticipation that MERF has sufficiently addressed the uncertainty and increased charter renewal risk of its LAUSD-authorized charters. The stable outlook also reflects our expectation that MERF will continue to attract sufficient students such that operations will remain positive and that its maximum annual debt service (MADS) coverage and days' cash on hand will not decline below current levels.

We could revise the outlook to negative if MERF fails to complete all required actions outlined in its settlement agreement with LAUSD or if concerns by the Fiscal Crisis Management and Assistance Team (FCMAT) or any of the organization's authorizers raise concerns that could impact any of its charters. In addition, we could consider a negative rating action in response to MERF experiencing significant declines in enrollment, liquidity, financial performance, or debt service coverage, or if the organization issues additional debt beyond what is expected without a commensurate increase in coverage and liquidity.

In our view, a positive rating action is unlikely given the significant organizational transition that is in process. Outside of the outlook period, a positive rating action could occur upon demonstrated stability by the foundation while it maintains positive operations and coverage and liquidity levels that are commensurate with a higher rating.

Enterprise Profile

MERF

MERF was founded in 1997 and oversees eight charter schools in the Los Angeles area and one charter school each in Santa Ana, 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. Management represents that all of its charters are in good standing. We also spoke with the authorizer at LAUSD CSD, but they did not comment on the charters' status and instead referred back to the settlement agreement and oversight reports conducted for MERF's schools. The 2014-2015 Annual Performance-Based Oversight Visit Report for MSA-1 dated Dec. 9, 2014 (issued before the settlement agreement) indicated that MSA-1 achieved a '3' (proficient) in three of the four areas being reviewed. However, the school received a '2' (developing) rating in the area of governance. Management indicated that it has either completed or is in the process of addressing all issues cited in the report. Given the renewals of MSA-6, MSA-7, and MSA-8, we expect all of the charters to remain in good standing, but we will continue to monitor reports provided by the authorizer to assess whether concerns could lead to future revocations or nonrenewal.

MSA-1

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 leased gym. MSA-1's demand profile is strong with enrollment at 518 in fall 2014, which is slightly less than the maximum physical capacity of 550 and charter capacity of 525. The school maintains a strong wait list of 293 students, equal to 57% of enrollment. Management expects enrollment to grow to 540 students in fall 2015, close to its physical capacity.

Enrollment and market position

MERF has a well-diversified enrollment base with each school representing no more than 15% of total enrollment. Enrollment in fall 2014 declined by 1.6% to 3,740. According to management, the decline was largely driven by a loss in students at MSA-5, which had to move from its North Hollywood site to Reseda, Calif., because its landlord did not renew its lease. Management projects enrollment to increase to 3,999 in fall 2015 although we believe this could be impacted by a leasing issue associated with its Santa Clara campus, which lost its lease and is currently searching for a new site to accommodate its student base. Should management fail to provide a site, a church could be leased at a lower enrollment level of 120 students.

Management and governance

As part of the settlement with LAUSD, there were several senior management changes at MERF, including the appointment of a new CEO and Superintendent, CFO, and chief administrative officer (CAO). Management also hired a new auditor. Although MERF has historically managed all business operations at each of the schools, it is now transitioning all back office services to EdTec, a charter school finance and operations service provider serving over 300 charter schools. In our view, this is a positive transition, which should help improve accountability and transparency at the organization.

Over the past year, there have also been changes at the board-level, including the addition of three new members and the loss of one board member for personal reasons. The LAUSD settlement agreement requires board membership to increase to nine members from its current seven by September 2015, and management reports that it has just one member to add to meet this requirement. Separately, MERF's board voted to expand the board to 13 members, and management plans to have the board fully staffed to this internal requirement by no later than February 2016. Regardless of its size, a single board will continue to be responsible for the management and governance of all 11 schools. Other changes at the board level include staggered terms and the establishment of governance committees. Finally, as part of the settlement, management is instituting more transparency and disclosure requirements at the schools. Although the management and governance at the foundation is under significant transition, which has its inherent risks, we view the changes positively and expect improvement in terms of accountability once the transition is complete.

LAUSD settlement agreement

In July 2014, the LAUSD CSD announced that it would not renew the charters of MERF's MSA-6 and MSA-7 schools. Further, in September 2014, the authorizer denied renewal to the charter of another school in the network, MSA-8. Many of the negative findings cited by LAUSD CSD related to management, accounting, and internal governance practices at the charter management organization (CMO) level. In March 2015, LAUSD and MERF entered into a settlement agreement to resolve the concerns previously raised, and the authorizer renewed the charter contracts for all three schools. As part of the settlement, MERF agreed to make a number of changes that have been completed or are in the process of being completed. We will continue to monitor progress on the organization's required actions and could take negative rating action upon failure to comply with agreed-upon actions from the settlement agreement if we believe it could raise the risk of charter nonrenewal. The institutional changes required by MERF include:

- Termination of its contract with Accord, a provider of education-related services, and agreement to not enter into any future contracts with the organization (completed);
- Agreement to be subject to fiscal oversight during fiscal year 2016 by the FCMAT or an equivalent organization (in process);
- Replacement of senior management positions, including the CEO, CFO, and CAO at MERF; the addition of three new board members; and the institution of staggered terms for all board members (completed);
- Limitation on fund transfers between schools or between schools and MERF's home office unless in accordance with generally accepted account principals for legitimate educational and operational expenses and only with board approval (in process); and
- Replacement of the independent auditor and several improvements to the auditing process (completed).

Financial Profile

State funding environment

On July 1, 2013, 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 student; and supplemental grants equal to 50% of the base grant provided for each student above the 55% threshold for economically disadvantaged and foster youth. Funding under the new formula began in 2013-2014, and per-pupil funding increased substantially. Although it is estimated that full implementation of LCFF will not be complete until 2020, the funding outlook for MERF is positive given its high portion of economically disadvantaged students. In addition, state deferrals are anticipated to end.

Operations

MERF had positive operations on a full-accrual basis in fiscal years 2014, 2013, and 2011 but experienced a deficit of $797,000 in fiscal 2012. Management indicated that this deficit was primarily caused by state deferrals that declined in subsequent years, and it projects further surpluses in the next couple of years. According to Standard & Poor's calculations, which incorporate the existing debt and leases, debt service coverage remained strong at 3.4x for fiscal 2014, an increase from 2.5x in fiscal 2013. Pro forma lease-adjusted MADS coverage is estimated at a strong 2.19x fiscal 2014 operations, assuming a lease-adjusted pro forma MADS of $3.4 million based on smoothing of the $9.1 million in potential new debt over 30 years at a 5% interest rate.

MSA-1 has improved its operating performance over the past three years. It had a full-accrual surplus in fiscal 2014 and 2013 of $808,000 and $492,000, respectively, after a deficit of $176,000 in fiscal 2012. Management has reported a surplus of $287,000 in the nine month year-to-date financials for fiscal 2015 and has budgeted for a surplus of $146,000 for fiscal 2016. Lease-adjusted pro forma MADS coverage was solid for the school, at 2.1x in fiscal 2014 based on lease-adjusted MADS of $637,000, which includes debt service and the school's gym lease rental expense.

Balance sheet and debt

MERF improved its liquidity from a days' cash on hand perspective in fiscal 2014, largely due to a reduction in state deferrals. As of June 30, 2014, MERF had $5.8 million in unrestricted cash, equal to 74 days' cash on hand, compared with $2 million, equal to a low of 27 days the prior year. As of March 31, 2015, nine months into fiscal 2015, MERF reported $11.2 million in unrestricted cash, and management anticipates maintaining these levels through the end of fiscal 2015. As of June 30, 2014, MERF's total debt outstanding was $8.3 million. With the possible addition of up to $9.1 million in new debt, pro forma debt would be $17.4 million. Lease-adjusted debt service remains moderate in our view, when including the bonded debt, at 9% of fiscal 2014 expenses. The pro forma lease-adjusted MADS burden remains moderate at 11%, assuming the pro forma debt is smoothed over 30 years at a 5% interest rate.

MSA-1 also saw improvement in financial flexibility from a days' cash-on-hand perspective over the past year. At the close of fiscal 2014, MSA-1 had $1.4 million of unrestricted reserves providing 114 days' cash on hand. This is up from $146,000 of unrestricted reserves at the end of fiscal 2013, representing 14 days' cash on hand. We expect MSA-1 to report improved operations and liquidity levels for fiscal 2015, with limited variability through the outlook period. Like MERF, MSA-1's lease-adjusted MADS burden is manageable at 14%.

Lease and expansion risk

MERF is exposed to lease risk as it currently has leases for 10 of its schools, with six renewed annually. In the past year, the lease for MERF's Santa Clara campus was not renewed, and management is currently looking for a new location to house its 484 students. Management indicated it can sublease from a church should another location not be obtained, but this would result in an enrollment decline to 150 students given the limited capacity at the site. For this reason and to account for this risk, the fiscal 2016 budget assumes that Santa Clara's home office contributions will be waived. While we view the conservative budgeting as positive, we believe the possible reduction in enrollment could lead to reduced operational health of MERF outside of the outlook period should a viable alternative not be found. We will continue to monitor management's progress on obtaining a viable site for this campus.

To address MERF's lease risk, management has indicated that its key focus is to increase its schools' site stability. To this end, MERF obtained approval for more than $17 million (50% grant-50% loan) from the State of California's Charter School Facilities Program to construct a new facility for MERF's Santa Ana Campus. Management has also indicated that, over the next year, it could issue up to $9.1 million in debt to acquire a permanent facility for its San Diego campus and to acquire a facility adjacent to MSA-1, allowing it to increase its overall enrollment. Management will develop a five-year master plan over the summer, which will outline expansion and facility acquisition priorities and timing. As part of this planning effort, management will evaluate further expansion, including the opening of an elementary school in San Diego and further expansion in the Santa Clara area, which could occur as early as fall 2016. In our opinion, management's plans should help to minimize its lease risk, but the organization could risk overleveraging itself. We also view expansion as presenting of risk of dilution of managerial and financial resources. Given that management is in its initial phases of planning, we will evaluate its expansion and acquisition plans once they are more fully defined.

Magnolia Educational and Research Foundation, California					
	--Fiscal year ended June 30,--				
	2015	**2014**	**2013**	**2012**	**2011**
Enrollment					
Total enrollment	3,740	3,801	3,654	3,164	2,595
Total waiting list	482	N.A.	N.A.	N.A.	N.A.
Waiting list as % of enrollment	12.9	N.A.	N.A.	N.A.	N.A.
Financial performance					
Total revenues ($000s)	N.A.	32,298	30,647	24,632	20,866
Total expenses ($000s)	N.A.	27,143	26,876	24,703	20,557
EBIDA ($000s)	N.A.	5,424	4,281	203	492
EBIDA margin (%)	N.A.	16.79	13.97	0.82	2.36
Excess revenues over expenses ($000s)	N.A.	5,155	3,771	(71)	309
Excess income margin (%)	N.A.	15.96	12.30	(0.29)	1.48
Lease-adjusted annual debt service coverage (x)	N.A.	3.37	2.50	1.06	1.27
Lease-adjusted annual debt service burden (% total revenues)	N.A.	6.9	8.2	7.0	8.1
Lease-adjusted annual debt service burden (% total expenses)	N.A.	8.2	9.4	7.0	8.2
MADS ($000s)	N.A.	2,851	2,528	N.A.	N.A.
Lease-adjusted MADS coverage (x)	N.A.	2.64	2.50	N.A.	N.A.
Lease-adjusted MADS burden (% total revenues)	N.A.	8.8	8.2	N.A.	N.A.
Lease-adjusted MADS burden (% total expenses)	N.A.	10.5	9.4	N.A.	N.A.
Pro forma MADS ($000s)	N.A.	3,437	2,637	N.A.	N.A.
Pro forma lease-adjusted MADS coverage (x)	N.A.	2.19	2.40	N.A.	N.A.
Pro forma lease-adjusted MADS burden (% total revenues)	N.A.	10.6	8.6	N.A.	N.A.
Pro forma lease-adjusted MADS burden (% total expenses)	N.A.	12.7	9.8	N.A.	N.A.
Total revenue per student ($)	N.A.	8,497	8,387	7,785	8,041

Magnolia Educational and Research Foundation, California (cont.)					
Balance sheet metrics					
Days' cash on hand	N.A.	79.0	27.1	73.6	6.9
Total long-term debt ($000s)	N.A.	8,338	345	2,341	525
Unrestricted reserves to debt (%)	N.A.	251.0	572.5	211.2	73.7
Unrestricted net assets as % of expenses	N.A.	29.5	10.3	4.2	10.2
General fund balance ($000s)	N.A.	N.A.	N.A.	N.A.	N.A.
Debt to capitalization (%)	N.A.	22.6	11.1	69.7	19.7
Debt per student ($)	N.A.	2,194	94	740	202

MADS--Maximum annual debt service. N.A.-not applicable.

Related Criteria And Research

Related Criteria

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