edtec CONNECT
Fall 2011 Volume 1

Bridging the Gap: Understanding Cash Flow Options in the Midst of Deferrals

By Bryce Fleming, Director of Client Management and School Finance, EdTec Inc.

As the California economy continues to suffer, the impact is felt by all, and charter schools are no exception. In addition to cutting funding rates, the state has increased the amount of revenue deferred to schools, with the current fiscal year experiencing the most severe deferrals that charters have seen yet. These deferrals affect all schools – small and large, new and old, urban and rural – and are truly debilitating to their cash flows. With state revenues delayed several months and into future fiscal years, charters must dip into any reserves to cover ongoing expenses. If there aren't sufficient cash reserves on hand, charters must take on the additional cost of borrowing to cover expenses while waiting on state payments.

"The deferrals implemented by the state may have made managing cash flow easier for [the state], but they have caused some very real financial stress and strain on my small charter school," explained Karla Branch, Executive Director of R.A.A.M.P. Charter Academy, a 175-student K-7 school in Antioch, CA. Branch is one of hundreds of school leaders across the state who, in order to keep doors open, has had to quickly assess her school's financial situation and make some very difficult decisions in the past several months.

For those looking at cash flow challenges this year, there are several financing options that may be a good fit for bridging your school's cash flow shortages. The following tools and explanations can help to inform your research. Final decisions should be made in counsel with your board and financial advisors. With accurate and up-to-date cash flow projections, a clear understanding of the problem well before the need arises, and a sense of the available options, you will be best prepared to pursue the right solution for your school at the right time.

How did we get here?

California is in a state of fiscal emergency; unemployment is still lingering around 12%, causing income and sales tax revenues to decline. The state simply doesn't have enough money on hand to pay its expenses and debt obligations on time. So, as part of the Budget Act, the Governor signed into law large deferrals of California's payments due to schools.

Understanding the deferrals. California cash deferrals began in 2003, but have increased in frequency and size over time, with 2011-12 being the biggest year for deferrals yet. The 2011-12 Budget Act calls for deferrals for all or part of eight different months of payments, with 61% of apportionments being deferred at some point this year and 38% being deferred into FY 2012-13. The chart below illustrates the monthly impact of deferrals this year.

2011-12 State Deferral Schedule

	2011-12													2012-13		
	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	TOTAL	Jul	Aug	Sep
Standard Apportionment	5.00%	5.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	9.00%	100.00%			
Deferrals	-5.00%	-5.00%		-9.00%				-8.41%	-3.53% -5.47%	-1.76% -5.89%	-3.36% -4.21%	-9.00%				
Repayments			2.82%				2.18% 5.00% 9.00%			3.53%				8.41% 1.76% 3.36% 9.00%	5.89% 5.47% 4.21%	
Actual Apportionment	0.00%	0.00%	11.82%	0.00%	9.00%	9.00%	25.18%	0.59%	0.00%	4.88%	1.43%	0.00%	61.90%	22.54%	15.56%	0.00%

	Deferral	% of Apprt. Deferred
July Apportionment Deferred Until September	2.82%	56%
July Apportionment Deferred Until January (New to 2011-12)	2.18%	44%
August Apportinment Deferred Until January (New to 2011-12)	5.00%	100%
October Apportionment Deferred Until January	9.00%	100%
February Apportionment Deferred Until July	8.41%	93%
March Apportionment Deferred Until April	3.53%	39%
March Apportionment Deferred Until August (New to 2011-12)	5.47%	61%
April Apportionment Deferred Until July	1.76%	20%
April Apportionment Deferred Until August	5.89%	65%
May Apportionment Deferred Until July	3.36%	37%
May Apportionment Deferred Until August	4.21%	47%
June Apportionment Deferred Until July	9.00%	100%
Total Deferrals	**60.63%**	**60.63%**
Total Inter Year Deferrals	**38.10%**	**38.10%**
Total Spring Deferrals	**41.63%**	**92.51%**
Total Spring Intra Year	**3.53%**	**7.85%**
Total Spring Inter Year	**38.10%**	**84.66%**

There were no state apportionment payments in July, August or October! Because the state sends apportionments at the end of the month, and there is a lag time for counties to process and send out payments to charters (7-21 days), the apportionments listed in each month aren't typically received until the following month. Keep this in mind for large monthly expenses such as payroll and rent; monthly apportionments might not arrive on time to meet regular monthly obligations even when they aren't delayed. Only about 21% of total revenue will be received before December 2011. ***From February through June, the majority (84%) of revenue will be deferred, which means almost no money will be coming from the state over that five-month period.*** Ultimately, 38% of the year's total apportionment will be deferred into the next fiscal year, making it very difficult for schools to meet current-year obligations. Although these projections are signed into law, they are subject to change. Keep tabs on the most current information released by the CDE.

Potential for midyear cuts. Adding further uncertainty to school funding is an automatic "trigger" built into the budget plan that will cut K-12 funding if state revenues do not meet the optimistic revenue projections used to balance the budget. Because state revenue assumptions are aggressive, it is a good idea to plan conservatively for a $250-300 per ADA funding rate cut in your forecast. If the budget cut happens, deferrals will stay in place. And, since the deferrals are based on a specific dollar amount, the percentage of funds deferred would *increase* if the trigger cut comes into play.

Now that we're here, what are the solutions?

CDE Charter School Revolving Loan Fund. As one of the lowest-cost sources of capital anywhere, the CDE Revolving Loan Fund is the option charter schools should look to first, assuming they are eligible. Schools that are still in their first charter term can apply for up to $250,000. The loan amount may be lower than $250,000, but schools can apply multiple times if the full $250,000 is not received the first time around.

Pros

- The current interest rate of around 1% is far superior to other forms of financing.
- Loan payments occur over multiple (up to five) years, so the loan will provide a longer-term cash cushion than other financing options.
- Repayments are taken directly from monthly apportionments, which reduce administrative hassle for the school.
- If state payments are delayed, loan repayments are also delayed.

Cons

- The program has been impaired by the state budget situation, making it a less reliable source of money now than it has been historically.
- Due to its revolving nature, the program relies on existing participants' payments, which are delayed by the deferrals, to fund schools newly approved for the loan. This has delayed the availability of funds for new participants.

Traditionally, the application is made available to schools by late summer/early fall, and once approved, schools receive their money a couple of months later. In this environment, the Request for Applications has not yet been released so schools are currently unable to apply. It has also become more difficult to qualify for the full $250,000 in recent years. If approved, schools cannot always expect to get the full award and should plan conservatively. For updates and more information, check the CDE website: http://www.cde.ca.gov/sp/cs/as/csrevloantoc.asp.

Deferral Exemptions. The state has offered exemptions from some of the deferrals. With a deferral exemption, schools are paid according to the normal legislative schedule, thus avoiding specified deferrals throughout the year. Exemptions can be requested from multiple deferrals or from just a single deferral. For 2011-12, charter schools were able to apply for exemptions from the intra-year deferrals (July/August/October 2011 and March 2012). Applications were due in the Spring of 2011. There will be another opportunity, in December, to apply for the March exemption and there will also be an opportunity to apply for an exemption from the June deferral that will be available in late February. For updates and more information, check the CDE website: http://www.cde.ca.gov/fg/fi/ir/.

Pros

- Deferral exemptions can be completed quickly and can be used to avoid fees associated with other cash flow solutions.
- It is a relatively straightforward application that requires the submission of a cash flow statement identifying the school's cash need and a short narrative on why the school would be insolvent without the exemption.

Cons

- While obviously helpful from a cash flow standpoint, political implications must be considered. When submitting an application, the school must certify that without that exemption, it would be insolvent, and the authorizer must review and sign off on the exemption.
- A school might not want to pursue the exemption if, for example, it has a tenuous relationship with its authorizer, or if it's about to enter the charter renewal process.

Negotiate with Vendors. Strong credit relationships are critical in times of slow cash flow. It is imperative to establish credit relationships immediately with major vendors. Seek out vendors who are willing to accept purchase orders and negotiate payment terms to coincide with cash flow. As much as is practical, limit vendor relationships to those that work extensively with public schools, or at least understand their unique financial needs. Engage in honest negotiations with your authorizer regarding payment delays for items such as encroachment or oversight fees. When making promises to pay, be realistic about the timing of funds. Once a promise to pay is made, work hard to meet that deadline.

Pros

- Negotiating with vendors is a relatively painless way to manage cash flow if you communicate openly, early, and regularly with your vendors and are realistic about when you can pay them.

Cons

- Times are tough for vendors as well so they may have constraints on their own cash flows that won't allow them to delay your payments.
- Because payroll is often a school's largest monthly expenditure, this strategy only gets you so far, as you can typically only negotiate on payments related to supplies and operational services.

This is a strategy that you should try in any case, as most vendors who are used to working with public schools are well aware of the state deferral situation. Your school is likely not the only one who is asking for extensions on payment dates.

Bank Loans and Lines of Credit. Loans from your bank (or other banks) are worth exploring.

Pros

- Lines of credit, in particular, can provide a great source of capital because of the flexibility in withdrawals and repayments. Interest payments can be minimized by only using the line when needed.

Cons

- The difficulty with both loans and lines of credit is that the current market makes them tough to obtain.
- Lenders are not usually familiar with charter school finance and do not know how to underwrite the risk.
- Charter schools have few hard assets to collateralize debt.
- Many schools, especially new ones, do not have a sufficient operating history and track record to give lenders comfort.

If you can manage to get approved for a bank loan or line of credit with favorable terms, take it! This has become an increasingly rare opportunity for charter schools. It's advisable to plan ahead to figure out when to draw down the line and when to repay it. Make sure that you get help from someone who is familiar with lines of credit to help put together the loan package and present your case to the bank. Because lenders often don't have a great understanding of charter schools, it is important to start early as the process can be lengthy.

Private Party Loans. Loans from a private party are not often readily available, but are worth exploring. A private party lender could come from a variety of sources: an authorizer, landlord, vendor or any other partner of the school.

Pros

- These people or organizations might be open to providing a loan to the school because they understand the school better than a bank would.
- Terms can be negotiated so they are beneficial for both parties. For example, an 8% simple interest rate with no upfront fees would be a less expensive source of capital than most currently available loan programs and would still provide an acceptable return for many lenders.

Cons

- There can be some political risk with approaching certain parties, such as authorizers or vendors, about a loan.
- Complicated legal issues can exist, so you should consult your legal counsel before going down this path.

Several potential difficulties exist in setting up a private loan. Lenders are likely not financial institutions and probably don't have the ability to run the school through a complex underwriting process.

TRANs and RANs. Tax and Revenue Anticipation Notes (TRANs) are short-term, interest-bearing notes that are issued by a district in anticipation of future taxes and other revenues to cover delays for general purpose and categorical funding. Revenue Anticipation Notes (RANs) are essentially TRANs for charter schools. With a RAN, a private investor has the authority to set the total amount of capital raised and the repayment terms.

Pros

- Annual interest rates tend to be low, currently within the 0.5% to 2% range.
- TRANs have the benefit of precedent; they have been available for over 20 years.
- Thanks to the presence of a state intercept mechanism, RANs have the ability to fund 85% of anticipated deferrals, so this solution can provide for a large need for schools that qualify.

Cons

- TRANs are currently available for big districts only.
- RANs are currently available for CMOs and large charter schools only.
- RANs are often challenging to deal with the expectations of a private investor, who can request additional security for the debt.
- Applying for a RAN can be a time-consuming process; the bond/note programs require several rounds of documentation and legal opinion. Despite the typically low interest cost, there are significant legal and investment banking fees at the outset, which can make it expensive for smaller deals.

These options are only available and make sense for a very limited number of charter schools. In general, TRANs are available for big districts and RANs are available for Charter Management Organizations or large charter schools. There are several groups working on making these options more widely available for charters. Efforts are underway to try to get districts to include charter borrowings in district TRANs. But for the time being, neither TRANs nor RANs are great options for the vast majority of charters.

Sale of Receivables. Receivables sales can be a low-risk vehicle for funders to finance charter schools. These programs involve the purchase by an investor of a receivable payable to a school, at a discount to face value, in advance of the payment date. Pricing reflects time value of money, and credit/collection risk. In other words, the state owes money to a school when it has approved a certain funding source and amount, but due to state cash constraints, isn't able to pay it – the school then has a receivable that it is owed by the state. The school is then able to sell that receivable to an outside investor who has the capital to provide the needed cash to the school upfront. When the money from the state arrives, it gets rerouted to the funder that bought the receivable, at which point the funder collects any program and discount fees associated with purchasing that receivable. In most cases, schools are selling their state apportionment via their certified ADA reports (i.e., PENSEC, 20-day report, P-1, P-2), but in some cases, they are also selling other receivables such as PCSGP funds, since many other revenue streams are arriving on a delayed basis as well.

Pros

- In an environment where it is difficult for charters to qualify for loans, receivables sales are a much more accessible solution than some of the other options mentioned above.
- Receivables sales have become a widely-used solution for schools of all ages and sizes mainly because the underwriting process is significantly faster and less stringent than that of a bank loan. From the time a school contacts a funder, a school can typically get its needed cash within 12 to 14 business days if its application is submitted quickly and passes the underwriting process.

Cons

- Cost of capital for funders of receivables purchasing programs remains high, so receivable sales can be relatively expensive, when looked at on an annualized interest rate equivalent basis.

If a school is going to do a sale, it's important to think strategically about which receivables to sell and to identify the amount truly needed and for how long. Program fees are typically collected up front based on the total committed amount. So while a lower percentage fee seems like a better deal, it is often not worth it to commit to sell more than a school needs just to secure a lower percentage on the program fee, since a lower percentage applied to a larger committed amount often results in paying more actual dollars for the program fee. For example, if you only need $100,000, it's much better to pay a 5% program fee to get that specific amount (i.e., a $5,000 program fee) than to secure a 2.5% program fee by committing to sell up to $1,000,000 (i.e., a $25,000 program fee). A school should remember that if it runs into a cash need in the future, it can simply do another sale later. Schools that commit more than they need up front, fail to adjust their budgets to reflect financing costs, or do not maintain expense discipline, are easily forced into a dangerous cycle of depending on the sales to keep afloat.

What's next?

Charter schools are facing the toughest time in their history, with funding rates at an all-time low and state deferrals more frequent and deeper than ever before. Though it may be daunting to follow the complexities of the deferral schedule, it is critical for school leaders to understand the timing and magnitude of any projected cash deficits and what can be done to proactively manage these shortfalls. Cash flow projections should cover a 12-month period and should be updated on a monthly basis. If a cash need is identified, start the process early for the financing options that have longer lead times, and remember that in any financing situation, the goal should ultimately be to meet cash flow needs while incurring the lowest cost on an absolute dollar basis.

Tips from the Trenches

By Karla Branch, Executive Director of R.A.A.M.P. Charter Academy

The state aid deferrals may have made managing cash flow easier for the state, but they have caused some very real financial stress and strain on my small charter school. Fortunately, I have found ways to manage cash in a pinch, and at times that pinch has been very tight! The following strategies have helped me to keep the lights on and the staff paid while I waited for my state receivables to arrive:

1. **Nothing is more valuable than good credit and a purchase order!** Having Net-30 or Net-45 day terms with vendors for vital, ongoing school needs such as books and classroom and office supplies is a must. If you are able to time your orders for these items so that the subsequent bill will not be due until your cash arrives, you too can be a savvy, P.O.-using administrator!

2. **Apply for the deferral exemptions.** On its face, the deferral exemption application makes it sound like you're captaining a sinking ship! It's not easy to face your authorizer and admit that without this exemption, your school will be insolvent. However, you may be pleasantly surprised to find that your authorizer is actually expecting you to ask for this. My school was granted the exemption and now cash is less of an issue, for the next several months anyway.

3. **Find outside financing.** This can be difficult because many banks and commercial lenders do not understand public school finance. Furthermore, public schools may be seen as risky borrowers because these lenders know enough to understand that our money comes from a cash-strapped and volatile state. However, if you are able to secure a line of credit, it could be a valuable resource from which to draw when cash is low and slow.

4. **When all else fails, sell your receivables**. There are companies out there who make it their sole business to buy our apportionments. They fully understand the nature of school finance, and have programs set up to help schools when cash flow is tight. This is not always the most cost-effective option, but it is one that is sure to work when cash is months away but bills (and payroll) are due today! Just make sure you clearly understand what you really need to sell to get by – selling more than you need to can raise your financing costs unnecessarily, and may put you on a selling treadmill that is expensive to get off.