

Stanford SOCIAL INNOVATION^{Review}

Supplement
Private Financing for Public Education
By Jessica Pothering

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criticism when they lose money on a deal. Philanthropic and impact investors can face criticism when they make money. In taking an equity stake in Anacor in addition to providing funding through the contract, the Gates Foundation took a broad risk as part of a high-level partnership to deploy Anacor's capabilities on otherwise neglected diseases. And with risk comes the possibility of reward.

"If you're going to go and collaborate with these young engines of innovation seeking capital, make the broad bet," says Klingenstein.

The US Internal Revenue Service (IRS) rules for PRIs state that financial returns cannot be a significant purpose of a PRI. But tax regulations don't prohibit financial gains as an unintended consequence. The financial outcome of the Anacor investment was indeed a side effect of the foundation's charitable purpose and strategic thesis.

It happens that some of the world's best technologies for global health are held by small companies that may achieve outsize financial returns. As fulfilling as it may be, research on neglected diseases may divert resources from these companies' core mission of commercializing drug candidates that might deliver a blockbuster drug that rewards shareholders. In those cases, equity investments can help align the incentives of private companies with the goals of the foundation.

Unlike a traditional venture capitalist, of course, any returns from PRIs go back to the foundation for philanthropic purposes. Pursuant to IRS rules, the profits from the investment will go back to the foundation's overall endowment; the returned principal must be redistributed through grants, contracts, or other PRIs within one year.

"The fact that the foundation's equity investment in Anacor has generated some positive financial returns that we've then been able to turn around and use to try to eradicate polio in Pakistan, to me is icing on the cake," says Julie Sunderland, the former director of the Gates Foundation's PRI team.

"But it's not why we do it," says Sunderland. "We do it because we want to partner with great entrepreneurs and great companies and great scientists and develop low-cost products for the poor. The focus on achieving results for our beneficiaries is clear in every investment we do." ♦

Private Financing for Public Education

Investing in collaboration between public school districts and charter school networks.

BY JESSICA POTHERING

In the back of the auditorium on opening day at Blackstone Valley Prep middle school, a petite woman with closely cropped gray hair seemed an unlikely pioneer of a new model of public school financing.

In the hallways, middle-school students slammed their freshly painted blue lockers and rushed to get into their classrooms before the first bell of the first school year at the newest school in Central Falls, R.I., a down-at-the-heels factory town of fewer than 20,000 people.

Gray skies and drizzling rain didn't dampen the mood as parents, teachers, administrators, and city and state officials toasted an unprecedented collaboration between a traditional public school district and a network of charter schools. For a moment at least, it seemed that district and charter schools—public schools serving the same families and communities—could not only coexist, but support one another.

Frances Gallo, the former superintendent of Central Falls, did not speak at the opening ceremonies. Under Gallo's leadership, and against enormous pressure from the teachers' union, Central Falls became the first school district in the United States to sign a facilities investment agreement as part of a broader District-Charter Compact.

After the event, Gallo explained why she bucked the opposition to welcome charter schools. "I felt I was everyone's superintendent," says Gallo, her voice rising. Nearby districts have been attracted to Central Falls' progress, and more than 20 District-

Charter Compacts have been signed across the country, making the vitriol and even death threats she received more tolerable.

The decade-long battle over the expansion of charter schools—public schools operated outside of the supervision and requirements of traditional school districts—has been fueled by competition for scarce education funding. The District-Charter Compacts, supported with \$40 million from the Bill & Melinda Gates Foundation, aim instead to share resources and expand the availability of financing while promoting collaboration between the two sectors.

The compacts are the Gates Foundation's latest strategy in a long quest to improve access to high-quality K-12 education. At the core of the foundation's facilities strategy are new financing mechanisms to catalyze private financing for public education, strengthening not only the emerging networks of high-performing charter schools, but the resource-strapped public school districts that serve the same communities. In addition to grants, the foundation has provided capital to finance charter school construction on public property and even in former district schools. The compact also obligates charter schools to help the district with teacher training and curriculum and the district to make resources available equitably.

Blackstone Valley Prep is a nonprofit charter school network with 1,400 students that has opened an elementary school and four middle-school campuses in Rhode Island. Its two new facilities in Central Falls are the first schools to open through the new financing strategy. The Gates Foundation made a 10-year, \$10 million loan to Civic Builders, a nonprofit charter school facilities developer, to be used for the proj-

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ects. Funds were drawn from this loan to purchase and renovate an abandoned skate park and a former Catholic school to build an elementary and middle school for Blackstone Valley Prep.

Central Falls was certainly in need of a new approach. The school district serves a city with a 29 percent poverty rate and a 50 percent high school graduation rate. In 2010, the school district fired the high school's entire teaching staff in a showdown over how to restructure the "failing" school under federal guidelines, then rehired many of them after a lawsuit. In 2011, the city declared (and emerged from) bankruptcy. Then the teachers' union mounted a fero-

have strong management and the flexibility to test educational innovations.

Demand is high: In many disadvantaged communities, families compete in lotteries for precious slots in high-performing charter schools. But the facilities at more than 50 percent of today's charter schools cannot accommodate enrollment growth. Most charter schools rent private properties.

To cover cost increases, such as rent hikes or the need to relocate, many must divert funds from their core educational missions. Seven out of eight operate as nonprofit organizations dependent on state funding and charitable donations. To grow, they need more space—and more capital investment.

Because charters often receive less public funding per pupil than traditional schools... private capital markets are vital for financial facilities and construction.

cious battle against the expansion of charter schools, which the union contended drained resources from traditional public schools.

TRIAL AND ERROR

If Central Falls' path to opening day was rocky, so have been the Gates Foundation's attempts to support systemic improvements in educational outcomes, particularly for disadvantaged students in resource-strapped communities.

In 1999, the foundation's K-12 education program had set a goal that by 2025, 80 percent of all US students will graduate from high school prepared to attend college. But by 2009, only 38 percent had graduated with the skills they needed for success in higher education. Since that year, the foundation has put up nearly \$100 million to scale up promising innovations in education nationwide.

Initially, the Gates Foundation embraced a strategy of "small schools" within larger public high schools. As the small school movement stalled amid mixed results, the strategy became less about the school itself and more about what was inside the classroom.

The search for more effective, scalable solutions led the foundation to public charter schools. The initial goal was to help strengthen and expand networks of charter schools, called charter management organizations (CMOs), that had proven programs and demonstrated results. The best charters

Because charters often receive less public funding per pupil than traditional public schools—\$2,247 less per student according to one recent study—private capital markets are vital for financing facilities and construction.

The Great Recession of 2008 froze charter school financing, which was strained even in better times. The bankruptcies of other borrowers caused bond insurers to tighten requirements. Credit ratings for the charter management organizations fell across the country. The financing freeze collided with growing enrollment, pushing many charter schools to their resource limits.

A Gates Foundation analysis had discovered that few loans to charter schools had gone bad. With bond insurers out of the market, the foundation stepped in with its own credit enhancements for new bond offerings. The foundation believed it could coax traditional lenders back into charter schools by demonstrating the credit-worthiness of the best-performing CMOs. Its research had shown that the academic performance of a school in the first two years of operation is a reliable signal for how the school will perform over time.

"The quality of the charter program is one of the strongest indicators as to whether it will be a good investment or not," says Noah Wepman, a senior program officer on the foundation's US K-12 team.

To test its ability to use program-related investments (PRIs) to lower the cost of capital for high-performance charter networks, the Gates Foundation in 2009 provided a \$10 million, 10-year credit enhancement to boost the credit rating of a \$68 million municipal bond offering by KIPP Houston. KIPP Houston was a reputable CMO that needed financing to build facilities for 7,000 new students. The foundation could have used grants or direct loans, but without the same effect on the marketplace and other investors.

The test worked. Credit-rating agency Fitch gave the bonds an A rating. KIPP received bond orders from 18 institutional investors totaling \$210 million—more than



three times the amount of its \$68 million issue. The credit enhancement resulted in cost savings of 50 basis points, or half of one percentage point. That saved KIPP \$300,000 per year.

A second credit-enhancement PRI in 2010 for Aspire Public Schools reassured other investors in the market and secured more attractive lending terms for charters.

As the Gates Foundation demonstrated the potential of credit enhancements to unlock the capital markets for these effective CMOs, others followed suit. Texas created its own bond guaranty program—the Texas Permanent School Fund—financed by oil and gas receipts. That fund, valued at more than \$17 billion in 2013, has opened up nearly \$1 billion in financing to Texas charter networks. That

model is being adopted in Arkansas, California, Colorado, Massachusetts, Michigan, Ohio, Utah, and Washington, D.C.

To scale up the potential impact of its education investments, the Gates Foundation backed a specialized school-financing intermediary to source deals, conduct due diligence, structure deal terms and necessary protections, and manage the investment risk. “Trying to kick-start the charter lending market on a transaction-by-transaction basis was not an efficient use of our time,” says Wepman.

In 2011, the Gates Foundation made a \$4.3 million low-interest loan to the Charter School Growth Fund, as part of a \$20 mil-

lions devised an unconventional plan to bring the two competing spheres together. An initial \$40 million grant and PRI portfolio for the District-Charter Compact has kicked off collaborations in 20 US cities where the foundation has been able to find strong leaders able to bridge long-standing divisions.

Frances Gallo was such a leader. When she first arrived in Central Falls, the new superintendent made a point of visiting the home of every student in the incoming kindergarten class. “As I was knocking on doors, I met many parents who told me their children were in the lottery for the Learning Community,” a promising new charter school. “They felt awkward talking to me.”

Gates Foundation’s District-Charter Compact team, and against enormous pressure from the teachers’ union, Gallo signed the compact. That made Central Falls the first city with a facilities investment agreement to support charter networks’ access to new school buildings.

The agreement allowed the Gates Foundation to test all its K-12 public education work in one place. The foundation built on its investment in the Charter School Growth Fund by enlisting Civic Builders. The foundation made a \$10 million, 10-year loan to Civic Builders to serve as subordinated debt on new school construction projects for Central Falls’ charter schools. That reduced risk for commercial financiers of Civic Builders’ projects, encouraging senior lenders to finance the facilities. With 0 percent interest for the first two years and 2 percent thereafter, the foundation’s loan reduced Civic Builders’ overall capital costs. The savings were passed to the schools as lower rents.

Blackstone Valley Prep became the first beneficiary of the District-Charter Compact’s financial support. Gallo helped identify a nearby public site to build a new elementary charter school, which opened its doors in 2014. A second PRI was used to buy and renovate a second building as a Blackstone Valley Prep middle school. Civic Builders retains ownership of both buildings, leasing them back to Blackstone Valley Prep with the eventual goal of selling them to the charter management organization.

The Gates Foundation will not know the full results of its loan to Civic Builders in Central Falls for some time. But the foundation’s District-Charter Compact effort is showing early signs of having as contagious an effect as its charter municipal bond credit-enhancements. The foundation is now exploring ways to leverage philanthropic and commercial capital on a national level and deploy it through a network of regional intermediaries.

Gallo retired in June 2015, leaving questions about how well the district’s new leadership will work with charter school networks like Blackstone Valley Prep. That uncertainty suggests the next stage of the foundation’s work: encouraging crossover leaders who have worked for CMOs and are now moving into district positions and vice versa. Such leadership may be what’s needed to make the District-Charter Compacts not just a temporary truce, but the basis of a lasting peace. ♦



School officials celebrate the opening of Blackstone Valley Prep middle school, in Central Falls, R.I.

lion debt fund to finance charter facilities. The fund supports high-performing CMOs across the country by providing loans to pay for high-cost items like rental payments and facilities financing.

SOCIAL COMPACT

The Gates Foundation believed that charter schools were an important factor in improving the US educational system, but its K-12 program wasn’t a charter-school-only initiative. The foundation’s goals for the US education system also focused on improvements in district public schools.

To combat the perception that the growth of charter schools depleted school district resources, the K-12 Program team

Gallo visited the Learning Community charter school. She was so impressed with the leaders and curriculum that she sent all of the district’s principals and even the teachers’ union president to see the work the school was doing. She wanted to dispel the myth that charters did not serve children in poverty. “They could see that the students in the class were the brothers and sisters of their own students,” Gallo says. She hired the Learning Community to work with the district’s first- and second-grade teachers on reading instruction. Test scores jumped.

New approaches and partnerships became even more critical when the city of Central Falls declared bankruptcy. So when the request for proposals came from the