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Muni monitor series: back to school edition

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Understanding the shifting environment for elementary and secondary education can help municipal bond investors identify opportunities and mitigate risk in the sector. Here we explore the investment implications of increasing charter school enrollment and the outlook for continued growth of this education sector, which currently represents $33 billion of outstanding bonds within the roughly $580 billion K-12 muni bond market.

THE NUVEEN MUNI MONITOR SERIES OFFERS INSIGHTS

The Nuveen muni monitor series explores the connection between effective muni bond investing and Americans' lived experience. Nuveen's muni credit analyst team – one of the industry's largest and longest tenured – constantly assesses the impact of the trends that influence muni credit quality across all market sectors.

Municipal bonds are a foundational element in Nuveen's proud heritage of investing to support public purpose – and an asset class that touches the everyday lives of all Americans. Munis fund essential infrastructure for state and local government; K-12 schools, colleges and universities; roads and airports; hospitals; water and sewer utilities; housing and more.

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Enrollment for traditional public schools has declined, ***while charter schools have gained students.***

Our research identifies what we believe are attractive investment opportunities, and much more. It also yields practical insights into what individuals can expect when it comes to the availability, operation and cost of services used daily – things like the price of an airline ticket or a hospital visit, the health of regional transportation options, the quality of local school systems or the dependability of critical utilities.

TOTAL PUBLIC K-12 ENROLLMENT DECLINES WHILE CHARTER SCHOOLS GAIN STUDENTS

As students head back to school across the country, the types of schools they attend will in some cases look different from the ones they attended as recently as pre-pandemic. The school choice movement, which seeks to promote alternatives to traditional district schools, has been in existence for decades. But the trend has been accelerated by the pandemic and legislation in many states that supports expanded school choice.

Public school enrollment fell across the country in the wake of the pandemic, and student count has still not recovered fully or evenly. Enrollment for traditional public schools declined, while charter schools gained students – a shift driven by demographics and a growing preference for new school choice options.

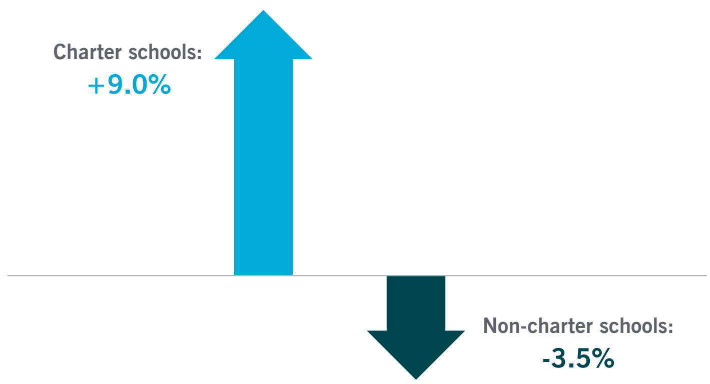
Between 2019 and 2023, overall public school enrollment – including public district and charter schools – fell -2.6%. Traditional K-12 public schools lost more than 1.5 million students, a -3.5% drop. Declining birth rates and a smaller school age population contributed to this drop. But many families' opting for charter schools, private education or homeschooling also contributed to the loss. In contrast to traditional public K-12 schools, charter schools gained close to 300,000 students, a 9.0% increase, during that time period.

In the 2022-23 school year, charter schools served 3.6 million students in about 7,800 schools or campuses. In that same school year, charter schools enrolled 8% of all public school students in the U.S. For perspective, total public school enrollment was more than 45 million students.

Several states' passing legislation favorable to charter school expansion and funding encouraged this trend. Additionally, school models offering the potential for a targeted curriculum focus (foreign language immersion, STEM or project-based learning, for example) have aligned with a growing national preference for additional education options.

Figure 1: Enrollment shifts from public to charter schools

Percentage change in school enrollment, 2019 to 2023



Data source: "Believing in public education," National Alliance for Public Charter Schools, December 2023.

Longer-term projections estimate a cumulative -6% decrease in K-12 enrollment nationwide through 2030, with the trend varying greatly by region. Lower birth rates have impacted all areas of the country, and uneven population trends have meant many districts – especially in the Midwest and Northeast – have seen steeper declines, while others have seen stronger growth trends necessitating new school construction. Texas projects strong growth in many communities, but other states, like California and New York, will likely see a decline.

*K-12 enrollment nationwide is expected to decrease a **cumulative -6%** through 2030.*

ENROLLMENT TRENDS INFLUENCE BOND ISSUANCE

Given increasing student demand for charter schools, we anticipate continued strong supply issued into the municipal market. 2021 and 2022 were banner years for charter school issuance, at more than $4 billion and $5 billion, respectively. 2023 and 2024 saw declining issuance as interest rates increased, though we expect issuance to pick up again if interest rates decline.

Most charter school bonds are issued into the market on a non-rated basis (approximately 50%), or carry ratings that are low investment grade (15%) or below investment grade (17%). Many charter school bonds that carry high investment grade ratings have support from a state bond enhancement program. In general, charter school investors can expect to receive a higher interest rate on bonds issued by these entities compared to public school districts. For example, average charter school bonds currently yield around 5%, while public school district bonds yield 3.5% to 4.0%, a difference of 100-150 basis points.

Typically, public school districts are highly rated and carry relatively low credit risk. The bonds issued by school districts are secured by dedicated property taxes levied specifically to pay debt service and cannot be used for operating expenses. Most school districts are subject to state-imposed debt limits and required to petition voters for approval to issue debt, providing investors assurance that the bonds and funded projects have community support.

In contrast, charter schools do not have the ability to levy taxes and are typically funded by state or local revenues determined by state-specific formulas tied to enrollment levels. Charter school bonds are typically secured by general revenues of the charter school, and there is no dedicated revenue stream to repay debt service like there is for public school districts. However, charter school bonds are often secured by a mortgage on the school facility, providing investors with marketable collateral.

IN-DEPTH CREDIT RESEARCH IS KEY

For charter schools, we focus on:

- Location in demographically supportive area with limited competition
- Solid academic performance and an experienced management team, focused on academics, marketing and financial health
- Differentiating curriculum or programs that set the school apart from other local public schools
- Strong legal and security provisions, including revenue pledge of the school, mortgage on the school facility, financial covenants and continuing disclosure provisions that promote transparency

For public school districts, we look for:

- Strong legal security pledge with bonds benefitting from an unlimited property tax levy and good continuing disclosure practices
- Healthy local economy with favorable demographics and enrollment growth
- Solid financial operations and management; budgetary flexibility provided by reserves and the ability to independently adjust revenues and expenditures

UNEVEN ENROLLMENT TRENDS AND INCREASED COMPETITION DRIVE EXPENDITURE GROWTH

Public education is facing new competition and funding challenges due to the overall enrollment decline, as well as shifting parent preferences leaning toward charter schools, private schools and homeschooling, in some cases funded by expanded state voucher programs. These enrollment and funding dynamics have credit quality implications for all K-12 schools - with winners and losers in each market segment.

Funding models for K-12 education vary by location, with funding shared between states and local districts pursuant to each state's specific funding formulas. In some states, local property taxes provide most of the funding with per-pupil state aid providing the rest. In others, districts are primarily funded by formula-based state aid with funding formulas dependent on size and need.

Charter schools are authorized and funded by states and in some cases compete with local school districts for available state and local resources. In recent years, state sponsored voucher programs, like expansive universal voucher programs in Arizona and Florida, have gained momentum. These programs provide public funding to families to pay for private or religious school tuition bills or home schooling, potentially reducing state funding available for public schools as enrollment shifts toward these other school options.

Regardless of school type or funding model, enrollment is a key revenue determinant for public schools. Increased competition for students puts pressure on districts to attract students, exacerbating a challenging financial situation if enrollment and revenues are simultaneously pressured as well.

Total per pupil expenditures increased 12.6% between the 2010-11 and 2020-21 school years after adjusting for inflation. Pressure to keep student/teacher ratios low, keep facilities and technology up to date and as provide support services as well as enrichment activities has driven spending increases. This level of increase will not be sustainable, especially if enrollment does not return to healthy levels in public school districts.

Nuveen continues to see value in ***charter school bonds****.*

SCHOOL DISTRICT BONDS ARE INSULATED FROM OPERATING RISK

Traditional public K-12 school districts issue long-term bonds typically secured by a general obligation pledge and a dedicated property tax levy to repay the debt. Most school districts are subject to state-imposed debt limits and required to petition voters for approval to issue debt, assuring investors that the bonds and funded projects have community support. Revenues collected from ad valorem property tax levies in place for debt service are legally unavailable for operating costs. This insulates investors from operating risk and budgetary pressures and ensures debt service is paid, even if the district has a structural budget gap.

THE BOTTOM LINE

While traditional public school districts are facing pressures such as enrollment declines and budget pressures, bonds issued by these districts have exceptionally strong security, backed by dedicated property tax pledges that are only available for debt service. This insulates investors from operating risk and budgetary pressures and ensures debt service is paid, even if the district has a structural budget gap. The strong security structure gives Nuveen confidence that investments in traditional school districts continue to be prudent and can add value to a diversified investment portfolio.

In general, charter schools located in demographically vibrant markets or sub-markets with solid fiscal plans and limited competition provide a good investment opportunity for muni bond investors. Charter school bonds have returned 11.8% over the past 12 months and provide an essential service. These bonds have strong security features, such as mortgages and financial covenants, that keep borrowers accountable while also providing bondholders with solid collateral in the unlikely case that the school does not perform. Nuveen continues to see value in charter school bonds and employs careful credit selection to drive investment returns.

For more information, please visit nuveen.com.

Endnotes

Sources

Yield data and sector size: Bloomberg, L.P.; Local Initiatives Support Corporation, "Charter School Bond Issuance, A Complete History," December 2022; Moody's Ratings, "Tightening operating environment will challenge a growing minority of districts" 23 Jul 2024; National Alliance for Public Charter Schools, "Believing in Public Education"; Center for Budget and Policy Priorities, "Expiration of Federal K-12 Emergency Funds Could Pose Challenges for States"; https://www.cbpp.org/research/state-budget-and-tax/expiration-of-federal-k-12-emergency-funds-could-pose-challenges-for; National Center for Education Statistics, "Revenues and Expenditures for Public Elementary and Secondary School Districts: School Year 2021-22 (Fiscal Year 2022)" 17 Jul 2024, https://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2024309; Barclays, "School Districts – Getting Ready for a Test," 31 Jul 2024; The 74, "Big Districts like Philadelphia 'Gamble' on Higher Spending as Enrollment Falls, Study Finds" 13 Jun 2024; https://www.the74million.org/article/big-districts-like-philadelphia-gamble-on-higher-spending-as-enrollment-falls-study-finds/; New York Post, "With so few students in class, why aren't public schools doing better?" 20 Jul 2024 https://nypost.com/2024/07/20/opinion/why-arent-public-schools-performing-better/; B.C. Ziergler and Company, "Charter School & Bond Market Overview," 10 Jul 2024.

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