Financing Child-care Centers in New Jersey: Innovative Investment Partnerships

A Discussion of the Unique Underwriting Aspects of Child-Care Facilities and A Look at Innovative Ways for Banks to Invest in Child-Care Facilities in New Jersey

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Preface

The Community Reinvestment Act of 1977 ("CRA") requires the Board of Governors of the Federal Reserve System and other supervisory agencies to encourage banks and thrift institutions to help meet the credit needs of their local communities, including low- and moderate-income areas, consistent with safe and sound operation of the institutions. To help achieve the goals of CRA, the Board of Governors established the position of Community Affairs Officer within each of the Federal Reserve Banks. The Community Affairs Officer is responsible for encouraging community development and investment by maintaining a community outreach program which gathers and disseminates information about community credit needs and resources to commercial lenders, state and local governments, federal agencies, community groups, and others. At the Federal Reserve Bank of New York, the mission is carried out by Community Affairs Officer and the staff of the Office of Regional and Community Affairs ("ORCA").

This paper discusses the strategies available in New Jersey and across the nation to financial institutions interested in investing in center-based child care. The paper represents only a sample of the strategies available for investing in child-care facilities. Financial institutions and others interested in investing in child-care facilities in New Jersey should use the information in the profiles to contact staff directly for more details.

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Introduction

The establishment of child-care facilities is a critical component of building economically stable communities. In low-income areas, welfare reform has brought thousands of parents into the workforce and new children into child care. Nationally, the increased demand for child care, particularly for infant/toddler slots, has exacerbated an already constrained supply of licensed facilities. In New Jersey in 1998, the New Jersey Supreme Court recognized the need for child-care slots in low-income communities with its historic *Abbott* Decision[1]. The *Abbott* Decision mandates 30 disadvantaged school districts to collaborate with community-based child-care centers to provide high quality, early-childhood education to all 3-and 4-year olds. Abbott continues to provide challenges and opportunities for providers and investors seeking viable strategies to address the substantial need for quality facilities.

A diverse set of revenues is needed to build and sustain child-care facilites. Currently, the revenue to fund these facilities comes from a mix of public and private sources. Table 1-[1] details the funding sources for licensed facilities in New Jersey. Parental fees are the largest revenue source, government funding is next, and business and philanthropy contributes the remaining funds to operate child-care businesses.

Many child-care operators, in light of overburdened government budgets and economically strained parents, are searching for alternative sources of funding. Some child-care operators are applying to banks and other investors for loans. Many of these operators have found it challenging to secure conventional loans. Non-profit intermediaries operating in the child-care facility loan market have suggested there are unique aspects of child-care facility loans that often hinder conventional loan approval.

The focus of this paper is to review the unique underwriting aspects of child-care facilities that often hinder loan approval and then discuss an investment structure, partnering with non-profit intermediaries, utilized by some banks serving New Jersey. The paper concludes by examining lending strategies, implemented in other states, where the government participates directly as a risk-sharing partner. These strategies include linked deposits, loan guarantee funds, and tax-exempt bonds.

The strategies profiled focus on vehicles to finance center-based child care. There are investment strategies to financing home-based facilities, but they are not the focus of this paper.

I. Unique underwriting aspects of child-care facilities

It is standard for small business owners to borrow funds when capital improvements are needed. In the case of child-care businesses there are certain factors, if present, that can make securing a loan difficult. The following are aspects unique to child care that may also hinder conventional loan approval.

- A lack of equity in the business;
- Vouchers as a revenue source;
- The staff's lack of financial expertise;
- Political risk associated with government subsidies; and
- The capacity to raise parental fees is limited.

A lack of equity in the business

Child-care facility owners often do not own the property in which the center is housed; they are simply making leasehold improvements to rented space. When child-care operators do own the space there is often not enough equity to secure a loan.

Parental-based vouchers as revenue source

Underwriters are typically uncomfortable with government vouchers that originate with parents. Under a parental voucher plan the cash-flow forecasts are based on parental enrollment. Parental enrollment is often not certain and can vary throughout the year. This lack of certainty increases the risk and therefore makes funding costs higher.

The staff's lack of financial expertise

Child-care operators' core competency often lies in child development and not financial management. The staff is often not equipped with the expertise required to package and manage a loan application. Salary constraints also make it difficult to recruit and compensate staff with financial expertise.

Political risk of government spending cuts

The government accounts for over 30% of the revenue for child care[2]. Underwriters are often concerned government funding cuts could impact the borrower's ability to repay their obligations.

Capacity to raise parental fees limited

Child-care operators serving low-income households must make parental fees affordable. In low-income families child-care costs already account for 16 percent of total earnings.[3]

Although there are challenges to underwriting loans to child-care facilities, banks interested in making child-care facility loans can participate in risk-sharing partnerships. Such partnerships include utilizing non-profit intermediaries, deposit links, facility loan funds, and tax-exempt bonds. Each one of these strategies enables the bank to share the risk of the loan. In New Jersey, these partnerships are primarily forged with private non-profit intermediaries. In other states public entities are risk-sharing partners.

II. Non-profit intermediaries specializing in child-care loans serving New Jersey

Non-profit intermediaries typically lend and provide technical assistance to low- and moderate-income communities that have been historically under-served. In New Jersey, many non-profit intermediaries have identified child-care operators as an undeserved market.

The non-profit intermediaries are working with banks and other investors to provide financial and technical assistance to child-care operators seeking child-care facility loans. These non-profit intermediaries specialize in the child-care underwriting process.

The intermediaries provide many interventions for operators throughout the loan process. For example, when a child-care operator is having difficulty building equity, the intermediaries often assist in developing a business plan that includes long-term strategies for equity building. In instances where the investors are concerned about the dependence on vouchers and government subsidies, non-profit intermediaries often can provide expertise and experience of working with these subsidies. The intermediaries can also assist in structuring transactions to mitigate some of the political risks associated with government subsidies. Another intervention the intermediary can provide is to assist the operator to develop a strategy to obtain alternative sources of funds. The non-profit intermediary may suggest the child-care center begin a fundraising effort. It is these and other interventions that make investment through a non-profit intermediary an effective way to lend to child-care businesses.

There are non-profit intermediaries serving New Jersey that have established initiatives aimed at mitigating the risks associated with lending to child-care businesses. These organizations are willing to partner with banks interested in lending to child-care providers. The following is a summary of organizations interested in partnering with banks to finance child-care loans.

Organization:	New Jersey Community Loan Fund ("NJCLF")
Programs:	Building Stronger Centers, Lighthouse Initiative, Urban Child-Care Initiative
Program Summary:	To address the lack of affordable child care in New Jersey, the New Jersey Community Loan Fund has developed initiatives to fund and improve the quality of child-care facilities. NJCLF, which currently receives support from local foundations, corporations and financial institutions, provides loans and technical assistance to child-care providers. The New Jersey Community Loan Fund also sponsors technical assistance workshops to help providers improve the quality of child care.
Track Record:	Since October 1998 the New Jersey Community Loan Fund has served 79 centers through Building Stronger Centers, The Lighthouse Initiative and the Urban Child Care Initiative. Beginning in 1989 the NJCLF has lent $8,557,967 to child-care facilities throughout New Jersey with a total development cost of $27.6 million. 4,564 children were served by these loans.
Contact:	Gregory Crawley Director Lending and Technical Assistance New Jersey Community Loan Fund 16-18 West Lafayette Street Trenton, NJ 08608-2088 Phone: (609) 989-7766 Fax: (609) 393-9401 Email: gcrawley@njclf.com Url: www.njclf.com
Organization:	Leviticus Alternative Fund ("Leviticus")
Program Summary:	Leviticus Alternative Fund is a private, nonprofit, community development corporation working to increase both the supply of affordable child care and the economic self-sufficiency of providers in New York, New Jersey, and Connecticut. Leviticus provides technical assistance and financing to child-

care providers. The Child Care Loan Pool offers zero-interest loans to child-care facilities.

Program: Child Care Loan Pool

Track Record: The Child Care Loan Pool totals $1.3 million. Since 1984 Leviticus has financed over 1,500 child-care slots serving low-income families. The majority of Leviticus' loans are in New York and Connecticut, but the fund management is actively seeking investments in New Jersey.

Contact: David Raynor, Executive Director
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Organization: Local Initiatives Support Corporation ("LISC")

Program: New Jersey Multi-City Program ("NJMCP")

Program Summary: The New Jersey Multi-City Program was established by the Local Initiatives Support Corporation to assist in the development of facilities that have a special significance towards the redevelopment of low-income communities in New Jersey. The program offers technical assistance, predevelopment financing and low-interest financing. The program is targeted to fourteen cities in New Jersey.

Track Record: The New Jersey Multi-City Program was started in 1997. Since inception the total program activity is $2,958,412-a portion of which was allocated for child-care investments. The affiliated equity investment totals $4,519,881. The program has 18 active Community Development Corporation relationships.

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Organization:	The Reinvestment Fund ("TRF")
Program:	Community Service Lending
Program Summary:	The Reinvestment Fund provides financing for a diverse set of neighborhood services. TRF also provides project financing for commercial facilities that stimulate economic and employment opportunities in neighborhoods. TRF is committed to supporting non-profits and for-profits that provide critical services to low- and moderate-income communities.
Track Record:	Founded in 1985, TRF serves as a regional community development financial institution ("CDFI") over a primary and secondary target area that includes eastern Pennsylvania, southern New Jersey, and northern Delaware. TRF currently manages a total of approximately $120 million in assets from more than 800 individual and institutional investors.
Contact:	Sara Vernon Sterman Program Manger, Community Service Lending The Reinvestment Fund Suite 300 North 71 Arch Street Philadelphia, PA 19106 Phone: (215) 925-1130 Fax: (215) 923-4764 Url: www.trfund.com
Organization:	The Enterprise Foundation
Program:	Enterprise Child Care
Program description:	Enterprise Child Care provides low-interest loans that can be used for acquiring property, pre-development costs, or as a bridge for the development and renovation of child-care centers.
Contact:	Suzanne Reisman The Enterprise Foundation Program Officer for Child Care Community Services and Planning 80 Fifth Avenue, Sixth Floor New York, NY 10011-9002 Phone: (212) 262-9575 ext. 149

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III. Investment Strategies in other States-Government as a Risk-Sharing Partner

The capital investment strategy utilized in New Jersey is primarily bank investment in child-care facilities with private partners. There are investment models implemented in other states where a government entity acts as a risk-sharing partner. These public-private models include: (a) linked deposits; (b) loan facility funds; and (c) tax-exempt bonds. The following is a sampling of these strategies.

(a) Linked deposits

Linked deposits involve a government entity depositing funds into a conventional lending institution for the specific purpose of enabling the bank to lend at a reduced rate to a specific borrower. The tool is often used to encourage lending to historically under-served businesses. A number of states and cities have used linked deposit strategies to leverage funds for low-income housing and small business development. With housing, the proceeds from deposits are lent to community-based nonprofit developers for the development of affordable housing. This strategy can also be implemented to lend, at reduced rates, to child-care operators serving families in low-income communities. Ohio appears to be the only state using this strategy for capital financing for child care. The following is a profile of the Ohio program.

Partnering Organizations:	Ohio Community Development Finance Fund (CDFF), State of Ohio Legislature, Department of Education and various private partners including banks.
Program:	Community Development Finance Fund Linked Deposits-Ohio
Program Description:	In July 1996, the Ohio Legislature appropriated $3 million for a child-care facilities fund. CDFF was selected to administer the use of the fund to leverage additional private-sector dollars. Linked deposits are one of the CDFF’s strategies for leveraging funds.

Track Record:	The legislature made a one-time allocation of $3 million. An additional $3 million has been generated by the sale of the bonds and the re-capitalization of those funds, a process known as securitization. The first $3 million funded 13 centers and enabled an additional $1 million to be recaptured. This $4 million leveraged an additional $11.5 million, for a total of $17.3. The Department of Education subsidized this effort with $600,000.
Contact:	James R. Klein, CEO Ohio Community Development Finance Fund 42 E. Gay Street, Suite 1000 Columbus, OH 43215 Phone: (614) 221-1114 Fax: (614) 221-743 Email: jrklein@financefund.org Url: www.dation.org

(b) Loan facility funds

Loan facility funds are used to construct, enlarge, extend, or otherwise improve community facilities considered as essential services in the community. The funds are available to not-for-profit child-care operators and typically the fund is a partnership between a public and private entity. Banks and other lending institutions invest in the facility fund and public entity allocates funds to guarantee outstanding debt. The City of San Francisco implemented a child-care facility loan fund. The following is a profile of the facility fund.

Partnering Organizations:	City of San Francisco, Low Income Housing Fund ("LIHF") and various private and public investing partners, including banks.
Program:	Child Care Facilities Fund ("CCFF")
Program Description:	The Child Care Facilities Fund offers access to conventional loans on favorable terms through CCFF guarantees or interest rate write-downs. This strategy allows for buying down of the interest rate and leveraging of private sector debt. The fund is guided by a 23-member Program Advisory Committee and is administered by the Low Income Housing Fund.
Track Record:	CCFF has raised a total of $4.88 million from private and public sources and has secured $10 million in loan authority from the HUD Section 108 Loan Program. These loans are backed by a commitment by the city Department of Human Services to subsidize up to 80 percent of the borrower's loan payments. The city also appropriates funds to repay the debt.
Contact:	September Jarrett The Low Income Housing Fund 74 New Montgomery Street, Suite 250 San Francisco, CA 94105 Phone: (415) 777-904? Fax: (415) 777-9195 Email: september@sf.lihf.org

(c) Tax-exempt bonds

Tax-exempt bonds can be issued for the purpose of constructing and renovating child-care centers. The transaction is structured in the following way: A facility fund borrows funds through tax-exempt bonds for the purpose of constructing and renovating a child care center. The bonds are then purchased by private investors and secured by (1) an equity contribution from the facility fund, (2) a debt service reserve fund raised by the facility fund, and (3) a commitment by the government to repay the debt over 10 years, subject to annual appropriation. The facility fund owns the buildings (although ownership will revert to the child care programs when the mortgages are repaid) and leases the buildings to the child care providers for $1 per year. The facility fund is completely liable for the debt if the state is unable or unwilling to pay.

This strategy was implemented in the state of Illinois. The following is a profile of the program.

Partnering Organizations:	Illinois Facility Fund ("IFF"), Illinois Department of Children and Family Services
Program:	Tax-exempt Bonds
Program Description:	The bond issues covered all costs associated with design and construction of the child-care centers. A request for proposals was issued jointly by the Illinois Department of Children and Family Services and the IFF. The child-care centers housed in the buildings served low-income working families. Unlike general obligation bonds, which the government body issuing owns, this strategy relies on bonds that are owned by a conduit.
Track Record:	The bonds were issued in November 1992. Land acquisition and design began immediately. The first building opened in September 1992, and the sixth opened in April 1993.

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Conclusion

Child care is a critical part of a community's infrastructure as it supports the ability of people to work.. In communities where families are transitioning from welfare to work access to child-care is an important part of a family’s ability to secure employment and build wealth. To ensure a sufficient number of child-care facilities communities must develop a comprehensive workforce development strategy that includes a plan for the financing of child-care facilities. The plan should include the participation of many partners include the government, the private sector, and the community.

Exhibits

Table 1-[1]

Number of Programs by Funding Source									
County	**Private**	**SSBG**	**Head Start**	**DYFS**	**Municip/Rec.**	**Cty.**	**Other State**	**Federal Other**	**County Total**
Atlantic	77	3	15	0	0	0	2	0	97
Bergen	365	7	6	0	12	1	0	0	391
Burlington	118	5	4	0	1	6	0	0	134
Camden	166	25	25	0	3	3	1	0	223
Cape May	28	0	6	0	2	0	0	0	36
Cumber.	40	2	5	0	0	0	1	0	48
Essex	323	54	60	0	11	3	7	1	459
Gloucester	109	3	3	0	1	7	0	0	123
Hudson	180	15	27	0	2	2	3	0	229
Hunterdon	69	2	0	0	0	0	0	0	71
Mercer	189	19	11	0	0	0	1	0	220
Middlesex	209	8	15	0	26	11	1	0	270
Monmouth	241	8	12	0	10	3	1	0	275
Morris	246	9	2	0	1	1	0	0	259
Ocean	136	6	7	0	4	0	1	1	155
Passaic	135	18	11	0	1	3	6	6	180
Salem	23	2	2	0	0	1	0	0	28
Somerset	163	4	2	0	1	1	0	0	171
Sussex	55	2	3	0	1	1	0	0	62
Union	217	18	14	0	11	0	6	0	266
Warren	42	1	3	0	1	1	0	0	48
Statewide	3131	211	233	0	88	44	30	8	3745

Source: New Jersey Department of Human Services, Division of Youth and Family Services, Bureau Licensing

Endnotes

[1] On May 21, 1998, New Jersey's Supreme Court mandated that children in New Jersey's Abbott Districts (the 30 highest poverty districts in the state) receive a high-quality preschool education beginning at age 3. Through this litigation, the New Jersey Supreme Court ordered the state to fund the provision of preschool services for 3-and 4-year old children in 136 school districts that serve New Jersey's low-income families. The court urged public school districts to collaborate with the existing community-based child care centers to provide these programs. The Abbott rulings establish the right of children in financially needy, urban communities to a "thorough and efficient" education under our State constitution, which includes the right to attend public school in buildings that are safe and adequate. One-quarter of the state's children live in the Abbott districts.

[2] Financing Child Care in the United States: An Expanded Catalog of Current Strategies-2001 Edition, Ewing Marion Kauffman Foundation.

[3] Giannareolli, Linda and Barsimantov, James, Child Care Expenses of America's Families, The Urban Institute, December 2000