



**Final Report  
Child Care Facility Capital Fund**

**Prepared by the Local Initiatives Support Corporation/  
Community Investment Collaborative for Kids  
in Collaboration with the Women's Community Revitalization Project**

**January 2006**

# Table of Contents

<b>BUILD and Pennsylvania BUILD.....</b>	<b>1</b>
Assignment .....	2
Policy Objectives .....	3
Nonprofit Financing Program Concept.....	3
Functional Roles .....	6
Proposed Application and Award Process.....	8
Financial Model for the Tax-Exempt Bond Program .....	13
Program Planning and Implementation .....	14
For-Profit Financing Program Concept .....	15
Other State Models for Development and Technical Assistance.....	16
Attachment 1: List of Interviews .....	18

## **BUILD AND PENNSYLVANIA BUILD**

The Build Initiative is a multi-state partnership that helps states construct a coordinated system of programs, policies, and services that:

- Respond to the needs of families
- Carefully use public and private resources
- Effectively prepare young children for a successful future.

It is supported by an Early Childhood Funders' Collaborative made up of 15 leading philanthropies. Pennsylvania is one of five states selected to participate in this national initiative.

To learn more about Pennsylvania Build, contact:

Carla D. Thompson, Special Assistant  
Office of Child Development  
Pennsylvania Department of Public Welfare  
525 Health and Welfare  
Harrisburg PA 17105  
([carthomps@state.pa.us](mailto:carthomps@state.pa.us))

People interested in Pennsylvania Build can also visit  
[http://www.pde.state.pa.us/early\\_childhood/cwp/view.asp?Q=104772&A=179](http://www.pde.state.pa.us/early_childhood/cwp/view.asp?Q=104772&A=179).

To learn more about the national Build initiative, visit <http://www.buildinitiative.org>.

## Assignment

The Commonwealth of Pennsylvania's BUILD Initiative has retained the Local Initiatives Support Corporation to develop a financing model to support a statewide child care facilities fund. The purpose of this fund would be to ensure the availability of affordable facilities capital and specialized technical assistance for the renovation, new construction or improvement of child care facilities across the state with the policy objectives of improving the quality and supply of child care programs and serving lower-income families.

LISC's national child care director and senior technical consultant have developed this financing model in close collaboration with the state's Child Care Facility Capital Fund Work Team, which includes members of the Department of Public Welfare (DPW), Department of Community and Economic Development (DCED), Pennsylvania Housing Financing Agency (PHFA), Pennsylvania Department of Education (PDE) and the Governor's Office. The LISC team has met twice with the Work Team, and has interviewed state agency representatives, child care practitioners and advocates, nonprofit facilities intermediaries, private lenders and foundations (a list of contacts can be found at Attachment 1). LISC has been collaborating with the Women's Community Revitalization Project (WCRP) on child care facilities work in the state, and WCRP's director participated in the initial Work Team meeting. In addition, we have reviewed various Pennsylvania state financing programs and have drawn on our knowledge of other state child care facility financing and policy initiatives.

Our work has been guided by the principles articulated at the "kick off" meeting with the Work Team on October 7, 2005 (below) as well as feedback on an interim report on alternative financing models presented on November 22, 2005.

### Guiding Principles:

- ▶ Link to quality (Keystone STARS)
- ▶ Serve low-income families
- ▶ Leverage non-governmental resources
- ▶ Begin planning in 2006 for possible implementation in FY 06-07
- ▶ Minimize financial impact on the Commonwealth's general fund resources
- ▶ Combine grants, loans, and technical assistance

This report describes two financing programs, one designed for nonprofit child care providers and one to meet the needs of proprietary child care businesses.

## Policy Objectives

The overarching policy objectives for these financing programs are designed to ensure the following:

- targeting facilities to the areas of greatest need, including underserved geographic areas, low-income families, and high need populations such as infants and toddlers or children with special needs
- encouraging collaborative efforts that will strengthen the early childhood education system in these communities,
- ensuring high quality programming, and
- producing well-planned and designed facilities that support programmatic needs.

## Nonprofit Financing Program Concept

Based on the meeting with the members of the Child Care Facility Capital Fund Work Team on November 22<sup>nd</sup>, the BUILD Initiative Capital Fund will combine elements from at least two of the models described in our interim report dated November 14<sup>th</sup>. It will have the following elements:

**Deep capital subsidy** - The economics of early care and education, especially for programs serving significant numbers of state-subsidized low-income children, severely limits the capacity of providers to support the capital cost of facilities adapted to support high quality programs. A substantial portion of the cost – perhaps 60-80% - must come from a new source.

The Capital Fund will provide a deep capital subsidy to nonprofit child care providers for facilities construction or renovation through a state commitment to service a majority of the debt on tax-exempt 501(c)(3) revenue bonds<sup>1</sup>:

---

<sup>1</sup> As described in the interim report to the Work Team, this type of revenue bond is attractive for a number of reasons: the tax-exemption translates into lower interest rates; bonds can usually be structured with a 30-year term – longer than is generally available through a commercial lender - and a number of child care projects could be financed using a single “pooled” revenue bond, thereby greatly reducing the transaction costs. Also, revenue bonds would be especially marketable because of the dedicated revenue stream committed by state government. Moreover, because the loan is secured by a revenue stream, rather than real estate, the borrowers will be spared a common problem for child care programs; the loan-to-value calculation used by lenders to underwrite real estate loans. Finally, unlike the federal “volume” cap on tax-exempt bonds issued by states to finance certain private activities, states face no comparable limit in issuing bonds on behalf of tax-exempt non-profit organizations. The state’s nonprofits gain the interest rate savings provided by their tax-exemption, and the state incurs no opportunity cost in terms of its tax issuing authority.

- The Commonwealth would commit the state to make monthly debt service payments equivalent to an average of 80% of the bond debt for each nonprofit child care center it agrees to support, over a period of 30 years.
- The impact of this program on the state's general fund could be minimized by the low cost of the debt, the long repayment term, and the capacity of the child care center to bear a higher proportion of the costs because of these low rates and long repayment terms.
- Providers will be awarded funds to participate in the revenue bond program based on a set of policy objectives to ensure that resources are used to build an adequate supply of high-quality facilities for low-income children.
- Eligible providers will be nonprofit organizations operating center-based child care programs that have demonstrated their commitment to quality through participation in Keystone STARS. A separate financing mechanism will be created to serve the needs of for-profit providers in the state (described later in this report).
- Participating non-profit providers will be expected to contribute financially by:
  - raising some equity, in the form of a donated site, grants, or the investment of unrestricted net assets, to cover between 10-20% of the total development cost.
  - paying debt service on between 15-25% of the bond.

Decisions on the actual amount of equity and debt each provider will be responsible for will be made on a case-by-case basis (proposed guidelines are described below).

**Industry-specific facilities intermediary** – A child care facilities technical assistance intermediary will be created to build and institutionalize the capacity to invest wisely in the physical infrastructure needed by child care providers. Its sole purpose would be to support quality early care and education by stimulating and facilitating investments in well-designed physical environments. The state's approach is about more than establishing a financing mechanism; the intermediary creates the institutional infrastructure to provide expertise and leadership in addressing the physical capital needs of Pennsylvania's child care industry. Funds to pay the operating costs of a technical assistance intermediary will come from state appropriations, foundation grants, and bond proceeds.

The Intermediary would provide the following resources and services:

- Project-specific technical advice from staff with real estate development expertise will enable less experienced, lower-capacity, and/or single-site child care programs to manage a real estate development project.
- Training workshops for providers will build their capacity to plan and develop a facility.
- Training workshops for development professionals working with providers on their facilities will focus in particular on the specialized resources and concepts that architects need to design quality environments for young children.

- Initial feasibility grants, predevelopment “recoverable” grants or unsecured loans will cover the cost of professional services and other soft costs incurred prior to the start of construction.
  - ▶ **Initial Feasibility Grants** – Many high quality providers serving the program’s target population will be unable to apply for bond financing because of the cost and expertise needed to meet the application requirements for an initial financing commitment. The regional Keystone Star staff might be asked to nominate providers to receive a grant of \$10-15,000 to carry out the necessary feasibility and planning activities to prepare a financing application. These nominations would be based on program quality, the provider’s facility needs, and the unmet child care needs for low-income children in the area. Those receiving the grants will also receive technical assistance from the intermediary. Grants should be made at least eight months in advance of the state’s request for financing applications in order to generate an appropriate pool of candidates. These resources might also be structured as “recoverable” grants so that some proportion could be recaptured from the bond financing. The source of funds for these grants might initially include start-up grants from foundations, as well as state appropriated funds.
  - ▶ **Predevelopment Recoverable Grants or Loans** – The intermediary will need a pool of high risk capital it can lend, or conditionally grant, to providers who are awarded an initial debt service repayment commitment from the state. Although a variety of circumstances could prevent a project from securing a final financing commitment, making repayment unlikely, the risk will be greatly reduced as compared to the grant funds advanced prior to the state’s initial financing commitment. The intermediary can also manage the risk through its loan or recoverable grant disbursement practices. For example, a disbursement of funds could be conditional on achieving certain milestones – a provider would not be able to draw down funds for environmental testing until site control is secured. This would ensure that the groups making good progress receive the planning funds they need to continue, while reducing the amount of funding that is disbursed but not repaid.

**Public Purpose Safeguards:** To preserve the ongoing public purpose of the state’s investment, the facilities funded through this program will be secured with a subordinated and deferred mortgage or comparable legal instrument requiring state approval for the sale or transfer of the building and would allow the state to foreclose on a non-performing provider and substitute a new owner that is able to meet the state’s requirements and objectives for delivering high quality child care services to low-income children.

**Start-Up Phase:** The program should operate for at least a five-year pilot period to allow providers to identify sites, plan the project and develop the facility. DCED’s Challenge Grant

program may have addressed some of the pent-up demand for new or improved facilities that were that were ready for construction. As a result, state should expect the bond program to start slowly, with the dollar amount of the bonds increasing over the first three years as providers create a pipeline of viable and high quality projects.

### **Functional Roles**

Implementation of this program will involve a wide variety of organizations and individuals responsible for carrying out specific roles:

**Lead Agency** – This would be the public agency that is directly accountable to the governor and legislature for the program’s overall design and implementation. We are assuming the Department of Public Welfare (DPW) would serve as the lead agency because of its role in overseeing the state’s child care system and Keystone Stars. However, there might be an interagency advisory body, similar to the Capital Fund Work Team. This agency or group of agencies would be responsible for: securing the state appropriation to service bond debt on terms that make the bonds easily marketable, establishing policy priorities, creating program guidelines, and selecting providers to receive capital subsidies.

**Technical Assistance Intermediary** – Another entity is needed to provide a series of technical assistance functions including predevelopment lending; building the capacity of providers and architects to incorporate best design practices into their plans, and to be a disinterested but well-informed third-party advisor to help providers work with development consultants or real estate development firms. The intermediary would include:

- 1) **staff and/or consultants** with real estate finance and development expertise and familiarity with the special needs of the child care industry to help center directors hire and manage a team of professionals; understand best practices in facility design; make legal arrangements, negotiate regulatory reviews, raise capital, etc.
- 2) **low-interest or interest-free “predevelopment” resources** to enable providers to access a team of third-party development professionals upfront in the planning process. Predevelopment resources are advanced and placed entirely at-risk during the planning phase to pay professional fees of architects, lawyers and others, and to secure site control, perform environmental testing or other site review. The fund would need to be able to offer an unsecured predevelopment loan product: with interest and principal deferred until the project raises all the funds needed to proceed.<sup>2</sup>

---

<sup>2</sup> Because of the high-risk nature of predevelopment lending, loss rates should be expected to be high. For that reason some intermediaries, particularly those assisting child care providers, offer an interest-free “recoverable grant” to cover predevelopment expenses. Since recoverable grants are essentially grants that get repaid when and if other capital is raised, the Fund would need to secure grant capital instead of loan capital as the funding source.

The intermediary's operating costs might be supported with a combination of appropriated state funds, Child Care Development Fund 4% quality set-aside, and philanthropic grants.<sup>3</sup>

The Intermediary function is often performed by a nonprofit community development intermediary experienced in working with community-based developers, has the staff expertise (or can acquire it) to advise providers on real estate development issues, not just finance ones, and has specific knowledge about the child care industry. Pennsylvania has a number of community development intermediaries involved in financing child care facilities, but none currently have sufficient geographic reach, capacity and technical expertise to be a perfect fit. The state also has several community design centers that work with the architectural community and community-based organizations, but they have very limited geographic reach and child care and real estate development expertise.<sup>4</sup> A number of other organizations around the country have set-up and operate child care technical assistance intermediary programs for some states. Pennsylvania could also create a quasi-public vehicle to carry out these functions.

We would suggest that the state prepare an RFP to determine which organizations might be able to expand and diversify their expertise and program offerings to meet the state's needs. Some joint ventures may be organized in response to the RFP.

**Conduit Bond Issuer** - Federal tax law requires that a state or public instrumentality (usually a state quasi-public authority, such as a housing or economic development finance authority) serve as a conduit borrower for tax-exempt bonds made to private entities. The issuer serves as a "conduit" between the borrower and bondholder (lender)

---

Ideally the fund would also have the ability to make small feasibility grants early on in the process to enable provider to put together viable applications for state capital resources.

<sup>3</sup> A potential source of funding for the technical assistance intermediary is philanthropic grants. Our interviews showed interest in early childhood education and an understanding of the facilities issue among a number of the larger foundations, including the William Penn Foundation, the Heinz Endowment and the Grabel Foundation. Each of these potential funders would need to work out certain issues related to geographic focus, their participation in a collaborative effort with the state, and limiting their financial assistance to a start-up phase that can be sustained thereafter either through ongoing state support and/or its own operations. Certain funders may also be willing to provide a program related investment to help capitalize a predevelopment loan fund. Based on our interviews with the three funders we estimate the likelihood of raising approximately \$5-7 million over a three-year period to cover the intermediary's initial operating expenses.

<sup>4</sup> Relying on our interviews with the director of some of these organizations, one of the more full-service design center is the Community Design Center of Pittsburgh. It makes small grants that enable nonprofits to pay for architects to put together an initial conceptual design and very preliminary cost estimate – approximately the level of detail that would be required to submit an application for the proposed bond funding. The Design Center also reported that their staff includes project managers who assist nonprofits to develop a scope of work and request for proposals for architectural services and even assist with the interviewing process. The Community Design Collaborative of Philadelphia works with the architectural community recruiting volunteers to provide site assessment and schematic design services.

but assumes no repayment obligation. The issuer will retain **Bond Counsel**, a law firm highly regarded for its knowledge of municipal finance to issue a legal opinion attesting to the bondholder's eligibility to claim a tax-exemption on the interest income generated by the loan. The issuer will also use the services of a **Bond Underwriter**, an investment banking firm, to structure the bond, perform due diligence, and market the bonds on behalf of the borrower and issuer. These three entities incur costs and charge transaction fees that the borrower pays using proceeds from the bond sale. While the Commonwealth of Pennsylvania has a number of public instrumentalities with the enabling authority to issue tax-exempt debt, the most likely conduit bond issuer for this program is either the Pennsylvania Housing Finance Authority, which has expressed an interest in the program, or a DCED-affiliated authority, such as the Pennsylvania Economic Development Financing Authority.

**Borrower** – The child care provider participating in this program must be a nonprofit organization that is legally eligible to borrow funds on a tax-exempt basis. The provider organization is the beneficiary of the state's capital subsidy and end-user of the facility (see selection criteria below).

**The Developer** – The developer is the entity that brings the expertise and coordination skills to move a project from an idea to a finished building ready for occupancy. The development process involves site assembly, permitting, and construction management. Some providers have the leadership or organizational capacity to be the developer with the services of a team of consultants. Alternatively a provider can “outsource” the development function to a project management or “turnkey development” firm under a contractual arrangement that requires the provider to purchase the finished building from the developer upon completion. Still a third option is to create a public authority or nonprofit development entity to develop the centers, possibly retaining ownership for some period of time before conveying them to the providers. The architect, real estate attorney, contractor and other consultants are hired by and work for the developer.

## ***Proposed Application and Award Process***

### **Application Process**

1. The lead state agency and the bond issuing agency will issue a Request for Applications to existing nonprofit center-based child care programs.
2. A set of quality design standards will be developed for the state-financed centers, including square footage per child, provision for child-height fixtures, bathrooms adjacent to classrooms, etc. The job of developing those guidelines should be subcontracted and, if the lead agency creates an advisory panel like the Child Care Facility Capital Fund Work Team, reviewed by that body as well.

3. The Request for Applications will require applicants to provide detailed submissions and back-up documentation to permit an assessment of:
- Organizational history and capacity
  - Management and leadership
  - Program quality
  - Facility improvement or expansion needs
  - Community needs and existing supply of child care
  - Identification of and evidence of availability of potential sites
  - Partnerships with other community agencies, clinics, funders, etc. to bring additional services to the children and families served by the center and resources to the facility development project.
  - Eligibility for 501(c)(3) financing
  - Financial condition
  - Description of proposed program
  - Preliminary facility design concept (relating physical design objectives of the project to programmatic goals and outcomes) and evidence that the planning incorporates “green building” design technology
  - Evidence of community support for the program and project.
  - Expected outcomes

### **Application Review Process**

The lead agency will convene a review team including the bond issuing agency, the technical assistance intermediary, and representatives from the agencies participating in the work group. In addition to reviewing written materials, members of the review team may conduct site visits to assess potential facility sites and program quality, and to conduct interviews with the applicant’s staff and board leadership.

Application review tasks will be delegated as followed:

- DPW will assess community need
- Keystone STARS will assess program quality and proposed improvement program.
- The Bond Issuing Agency will assess each application’s eligibility and financial suitability to participate in a pooled 501(c)(3) bond.
- The Intermediary should carry out or contract with a child care finance consultant to conduct an assessment of each applicant’s financial management capacity, business plan and financial projections to determine whether the applicant has the organizational, management and financial capacity to develop the project and operate it on a sound financial basis.

- The Technical Assistance Intermediary will assess the potential of each applicant's proposed site, development strategy, and the plausibility and quality of the initial facility design concept.

The application review process will cover the following:

### 1. Organization

- **Ownership & Governance** – The organization has an appropriate ownership structure with an active, involved and appropriately structured governing body that can provide strategic direction, both programmatically and from a business perspective, and can provide ultimate accountability.
- **Organizational Leadership** – Ideally the provider should possess a compelling vision; have a strong belief in the proposed project; be able to effectively communicate that vision, and demonstrate the ability to mobilize internal and external support for the proposed project.
- **Financial Management** - The provider should be financially sound and have a financial accounting system that is well designed, appropriately staffed and supervised and which is capable of producing regular and reliable reports on the organization's financial status.

### 2. Program

- **Program Quality** – There should be evidence that the provider is strongly committed to operating a high-quality, developmentally appropriate early care and education program. In addition to participation in Keystone STARS and having earned a certain number of stars, such evidence might include: a broad vision of early childhood education that embraces comprehensive services; sustained commitment to training & quality improvement, earned NAEYC accreditation or ability to demonstrate significant progress towards accreditation (e.g. has completed the self study). The proposed facility project should be tied to an overall vision of enhanced program quality.
- **Management** – The management team includes someone with enough training and experience in both early childhood development and employee supervision to direct a high quality program and provide the supervision and support needed by program staff.
- **Business Feasibility** – The provider or project sponsor will need to make a persuasive case for the viability of the child care business including:
  - evidence of effective demand for the provider's services such as that obtained through a market study, community assessment or other reliable tool;
  - multi-year financial projections demonstrating sufficient operating income to deliver those services and repay debt on the project;
  - realistic cash flow projections to establish the business' cash requirements;

- financial commitments sufficient to satisfy the business' projected operating needs,
  - plans for marketing the program to achieve projected enrollment (if expanding); and
  - a plan for recruiting and retaining enough qualified staff to support an optimal staffing pattern (if expanding).
- **Need** – Debt service support should be committed to projects that serve a minimum percent of low-income children and populations (e.g. infant/toddler care and programs for children with disabilities) and regions that are currently under-served.

### 3. Facility

- **Project Feasibility** – During the course of the project planning process the provider or project sponsor will need to make an increasingly convincing case that the proposed facility project is feasible. Ultimately, to be feasible, the project will need:
  - site control;
  - a site that is environmentally safe (as demonstrated through environmental surveys), appropriately located, and can be brought into compliance with all applicable laws and regulations;
  - a real estate development team with the experience to successfully implement the project;
  - a facility plan that will yield an appropriate learning environment for young children, and
  - a viable facility financing plan.
- **Community Support** – The project sponsor should be able to demonstrate support for the project from key community stakeholders.
- **Quality Space** – The proposed facility must at a minimum meet all applicable state child care licensing regulations, be a participant in Keystone STARS, having earned a certain number. In addition, the proposed design should be in concert with “best practices” for child care in terms of proposed group sizes, available square footage, and overall quality of the learning environment for young children. Through its capital subsidy, the state should seek to create model child care facilities that provide an especially high-quality environment for children and staff.

### Award Process

The debt service commitment will occur in two stages, including a preliminary state commitment made early in the planning process and a final commitment when the project is in the final planning phase<sup>5</sup>:

---

<sup>5</sup> Seventy-five percent of the available funding will be awarded and 25% of the debt service authority will be retained as a pooled contingency fund that can be awarded as needed at the final commitment stage. The contingency will not be treated as an entitlement to grantees but will instead be awarded based on merit and need as final costs become known. This contingency is needed because project costs are invariably underestimated during early project planning.

**Stage 1:** The following activities will happen simultaneously:

- a) The state issues preliminary commitment letters for a specified amount of debt service support<sup>6</sup>
- b) The commitment will require that the providers complete the following within 9 months:
  - secure site control
  - complete facility design program, schematic design phase and design development phase (but not construction drawings)
  - submit reliable construction cost estimates
  - submit results of environmental testing
  - provide operating budgets
  - provide evidence of matching financing commitments
  - produce binding agreements from tenants and/or programmatic partners
- c) The Technical Assistance Intermediary will make a pool of flexible low-cost bridge financing available to providers receiving an award of state debt service support to cover the upfront costs of site acquisition, site analysis, professional fees of architects, lawyers, etc., and other pre-construction costs. These costs vary considerably from project to project, however, it is estimated that each project will need \$100,000-\$150,000 prior to the construction loan closing. Incorporated into this estimate is the expectation that some costs incurred during the predevelopment period can be deferred until the construction loan closing.
- d) The Technical Assistance Intermediary will provide individualized technical assistance to providers awarded preliminary commitments by the state. This assistance will enable many of those providers to complete the required real estate development steps to secure a stage-2 commitment. In addition, resource materials will be developed for providers and architect training workshops will be delivered on: 1) child care design, development and

---

<sup>6</sup> The average debt service award will be roughly 80% of the bond repayment, although this will vary project-by-project based on both financial considerations (size of budget, ability to support debt payments, ability to raise equity contributions, and current occupancy costs) as well as policy objectives (the number of low-income children served, the need for services in a target area, the ability to serve special needs children or infants and toddlers, and the quality of the program). With these factors in mind, the state will need to establish priorities to ensure that its limited resources are targeted effectively and strategically. For example, certain providers, especially smaller centers serving a substantial portion of lower-income subsidized children, will have small and very tight budgets, with limited ability to support debt. Other providers may be larger and have more financial resources, but have achieved the highest level in the STARS program. Based on the state's policy decisions, it would be possible to come up with a basic formula along with guidelines that will allow the lead agency to determine the level of debt service provided to each applicant. The state could also decide to allow applicants to appeal the debt service award level based on special circumstances.

financing for child care providers; and 2) best practices in child care facility design for architects retained by the selected programs.

- e) Upon preliminary designation by the state to receive debt service support, the Bond Issuer will vote on a set of findings regarding the eligibility of each of the organizations and proposed projects for financing. This will permit subsequent predevelopment costs to be financed with the proceeds of the bond sales.
- f) Roughly half-way into the facility design process stage of planning, plans will be reviewed by a consulting architect experienced in early childhood facilities design and a construction manager, to suggest design changes designed to improve the quality of the facility and to do early stage cost engineering.

**Stage 2:** Within nine months of receiving a preliminary commitment, providers need to produce draft construction and contractor bid documents, produce a development cost estimate with a detailed project development sources and uses budget, evidence of an equity contribution, site control, and a qualified developer or development team. The state can provide extensions to providers who are making good progress but have yet to complete these tasks.

- a) The Lead Agency is responsible for coordinating the review of the proposed facility plan and costs with the Bond Issuer, and will adjust the level of the state's debt service commitment as necessary. The Intermediary may be consulted on the project review as well.
- b) The Bond Issuer will review each organization's submission and the state's debt service commitment, and, if satisfactory, the state will issue a final debt service commitment.
- c) The Bond Issuer will prepare to issue bonds to finance the project.

### ***Financial Model for the Tax-Exempt Bond Program***

Accompanying this report is an Excel file – *PA Bond Analysis Final Report* – containing a financial model for the tax-exempt bond financing program. It will permit policy makers to test a variety of assumptions about the following:

- ▶ the number and size of centers to be developed;
- ▶ the scope of the project (modest vs. major) and type of development (new construction vs. renovation);
- ▶ the state's annual funding commitment;
- ▶ the amount of provider equity and debt contributions;
- ▶ the effect of debt service on the provider's operating budget; and

- ▶ the pace of development and the number of years over which center development will occur.

The model also includes a *very* preliminary operating and predevelopment lending budget for a technical assistance intermediary. This multi-year budget ties directly to and automatically adjusts the level of center production and bond financing.

The Excel file contains four worksheets that are numbered and labeled. The spreadsheets are sequenced to guide policymakers along a decision path:

1. ***Size of Bond Prog*** – This worksheet uses a single average project size and cost, and shows the state debt service cost for bond programs of four different sizes. This model permits the user to compare the present value of different size bond issues to show how these assumptions translate into an annualized cost to the state; financial burden on providers; number of projects financed; and number of slots added or improved. This sheet will be helpful in guiding some initial but key decisions about program design.
2. ***Projs of Diff. Size and Cost*** – Instead of working with an average project, this worksheet allows you to work with six different types of projects, based on the number of children in a small, medium and large center, and project type/scope – modest renovation or new construction/substantial rehabilitation.
3. ***Pace of Bond Sales*** – This sheet is linked to the previous one, so the dollar value of bonds issued in each year is calculated based on the bond size in sheet 2. Since it will take some years to develop projects and to build the pipeline, this worksheet allows the use to test out different development schedules.
4. ***Intermediary Budget*** – This sheet is also linked to the previous worksheet. As variables are adjusted in either sheet 2 or 3, these changes will be reflected in the intermediary budget. However, it should be noted that the budget is highly speculative at this point. The assumptions will need to be carefully evaluated and most likely revised.

### ***Program Planning and Implementation***

A second Excel file – *Program Timeline* – accompanies this report. It contains a timeline for planning and implementing all of the financing and technical assistance mechanisms discussed in this report. The timeline covers three and a half years – the balance of the current fiscal year as well as fiscal years '07-'09.

The time line assumes a very aggressive set of deadlines. The ability to meet these deadlines will depend on the state's ability to commit a sufficient level of funding in a timely way, and draw on the time and expertise of internal agency staff and whatever outside expertise is determined to be required. Based on our discussions with the Work Team, we adopted this time line based on the assumption that the Work Team will attempt to get an appropriation of funds to support this initiative for the next fiscal year.

## For-Profit Financing Program Concept

Federal tax policy has increasingly sought to limit the issuance of tax-exempt debt to finance private business activities. The Federal Tax Code identifies a limited number of private activities that still qualify for tax-exempt debt, but child care is not among them. Moreover, each state is limited in the amount of tax-exempt private activity bonds it can issue. This “volume cap” has forced states to ration this bond issuing authority. These restrictions do not apply to nonprofit organizations. As a result, the state needs a different kind of program to stimulate capital investments in for-profit centers.

However, certain types of private businesses are eligible for more modest state and federal programs designed to make it easier for them to raise debt capital. These are programs that are only available to for-profit enterprises. The most common programs are those offered by the US Small Business Administration in partnership with local lending institutions. These include a loan guarantee and a subordinated loan product.<sup>7</sup> In addition, through the Department of Community and Economic Development, Pennsylvania offers some other favorable loan products to small or minority-owned businesses and to businesses located in certain economically distressed neighborhoods. The most straightforward approach the state could take to assist proprietary providers would be to market these programs to the child care industry. However, the state could try to develop something a little more ambitious, which could also have the goal of supporting for-profit providers serving lower-income and/or underserved communities or populations in the state.

A meeting of several leaders in the state’s commercial banking community should be convened to explore their interest in joining a lending pool for proprietary child care facility loans. This collaboration might also include existing community development finance institutions (CDFIs).

The partnership’s goals would be to:

- ▶ lower some of the barriers proprietary child care centers encounter when they seek loans to finance capital improvements, in particular the lack of sufficient collateral
- ▶ minimize the upward pressure risk has on interest rates, and,
- ▶ if possible, maximize amortization schedules to make the loan more affordable.

---

<sup>7</sup> The **SBA 7A Loan Guarantees Program** provides a 75% (or under certain circumstances 85%) guarantee on bank loans of less than \$2 million. 7A allows lenders to charge the prime rate [currently roughly 6 ¼%] plus 2 ¾ for loans with a term of 7 years or more. Loans can be used for fixed assets, such as real estate, construction costs and equipment purchases, and also working capital. The term can be from 15-25 years. The **SBA 504 Direct Loan Program** finances real estate, building construction, and equipment. The 504 program involves a fully-secured bank loan for 50% of borrowing amount and an SBA certified development company taking a second mortgage on 40%. SBA’s loans offer a fixed and generally lower rate than commercial rates of interest — slightly below prime plus 2 ¾ percent for origination and servicing fees. The term on 504 real estate loans is 20 years and, on capital equipment loans, 10 years. The maximum 504 loan is \$1.5 million with public policy priorities allowing up to \$2 million (this might include child care).

These financial institutions could form a lending consortium and, working with the state, create a more attractive loan product for proprietary child care businesses. For example, the program might combine a state guarantee of some proportion of long-maturity participation loans granted by the bank consortium. One of the banks or a CDFI could serve as the lead lender. The banks would benefit from the risk reduction associated with the state's guarantee. They would also realize two additional benefits. First, pooled lending allows the banks to reduce their exposure to loan losses by sharing them with other lenders. Second, the program guidelines would ensure that these loans would be seen as meeting their community credit needs under the Community Reinvestment Act (CRA). Since its passage in 1977, most banking institutions have embraced the CRA mandate both for regulatory reasons and to express the company's commitment to the community.

## Other State Models for Development and Technical Assistance

A number of other states have elevated facilities as a priority, and have approached the challenge of providing development technical assistance in a variety of ways. Vermont outsourced its facilities development program to a statewide intermediary and, because of the intermediary's limited knowledge of the child care industry, hired a national intermediary to build the local organization's capacity and expertise. Rhode Island, lacking an appropriate statewide agency or organization to be a child care facilities intermediary, formed a public-private partnership to fund a national organization to establish a statewide intermediary for the child care industry. Illinois selected an existing community development intermediary that specialized in financing nonprofit facilities to actually develop and own child care facilities which were later conveyed to nonprofit child care organizations.

- ▶ **Vermont:** The State of Vermont has developed a modest child care facilities grant program. It is funded with state appropriations and the proceeds of the sale of "Building Bright Futures" license plates. To administer the program, leverage debt and provide technical assistance, the state identified an existing nonprofit community loan fund that offers low-cost loans and some business technical assistance designed to benefit low- and moderate-income Vermonters. However, the intermediary lacked knowledge of the child care industry and had limited real estate development technical assistance delivery capacity. To increase the intermediary's capacity, the state provides an operating grant using Child Care Development Fund (CCDF) quality set-aside funds to support staff, and hired a national community development intermediary to provide training and ongoing technical assistance and mentoring to the local fund's executive director and loan fund manager. Vermont has also delegated most of the child care facility grants administration to the loan fund, which typically uses those funds in conjunction with their low-interest loans.

- ▶ **Rhode Island:** Child care advocates and policy makers in Rhode Island sought to build the supply and quality of child care facilities. Finding no existing state agency or organization able to provide capital and technical assistance statewide, a public-private funding collaborative formed to provide financial resources to support a national community development intermediary with extensive experience in child care facilities development and finance. That intermediary also benefited from access to the parent organization's infrastructure and loan capital. The state's Department of Human Services committed \$1.25 million from its Child Care Development Fund quality set-aside to support the operations the facilities fund over a five-year period. These funds were matched by foundation and corporate partners. Some of their funds were used to provide a shallow interest rate subsidy on the loans. The balance is used to fund a broad range of technical assistance, training and capacity building, and planning grants to support child care facilities development – including nonprofit and forprofit centers as well as family child care homes.
  
- ▶ **Illinois:** In Illinois, the state partnered with a statewide nonprofit community facilities intermediary, the Illinois Facilities Fund (IFF), to launch a revenue bond program with state debt service support. Under the Child Care Facility Development Program, funded by the Illinois Department of Children and Family Services, the state committed to make debt service payments over the next ten years to retire a tax-exempt bond issued on behalf of IFF. The Fund used the bond proceeds to build seven child care facilities for nonprofit agencies serving low-income children, jointly selected by IFF and the state. After the state fully repaid the bonds, the Fund agreed to convey ownership of the facilities to the seven nonprofit organizations. IFF served as the developer, and hired a single team of architects and other development professionals to design and construct the new centers on behalf of the providers. The result was seven well-planned and high quality facilities over a relatively short period of time, although some providers may prefer to have more control over the design and development process and select their own locally-based consultants.

---

## Attachment 1: List of Interviews

### State Agencies:

- Harriet Dichter, Office of Child Development/Department of Public Welfare, Department of Education
- Debi Mathias, Office of Child Development/Department of Public Welfare
- Linda Brown Warren, Department of Education
- Carla Dixon, School Construction Finance, Department of Education
- Brian Hudson, PA Housing Finance Agency
- Bryce Maretzki, Department of Community and Economic Development
- John M. Lori, Department of Community and Economic Development
- Danielle Narkin, Department of Community and Economic Development

### Child Care Providers and Advocates:

- Rina Nerlich, Child Development Center, Franklin, PA
- Mardy Isler
- Sharon Ward, Philadelphia Citizens for Children and Youth
- Mary Graham, Children's Village
- Terry Casey, Pennsylvania Child Care Association
- Joan Benso, Pennsylvania Partnerships for Children

### Private Foundations:

- Ronny Bloom, William Penn Foundation
- Marge Petruska, Heinz Endowment
- Emily Watson, Grabel Foundation

### Nonprofit Intermediaries:

- Bill Thomas, Women's Community Revitalization Project
- Sara Vernon Serman, The Reinvestment Fund
- Joanne Bursich, Nonprofit Finance Fund
- Liz Miller, Community Design Collaborative of Philadelphia
- Anne-Marie Lubenau, Community Design Center of Pittsburgh

### Banks:

- David Gibson, PNC Bank
- Sally McGrady, PNC Grow Up Great