



# Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Kay Winer

**SUBJECT:** San Jose Repertory Theatre  
Loan Options

**DATE:** September 11, 2006

Approved

Date

9/12/06

## RECOMMENDATION

Accept the report on loan options for the San José Repertory Theatre (REP) in the amount of \$1 million.

Take no action on any of the options until the City Auditor completes a full financial analysis of the San José Repertory Theatre. A partial report will be presented on September 19. The full report will be presented to Council for discussion at the September 26 meeting.

## OUTCOME

Full information from the Auditor is a critical element in assisting Council to determine which of the loan options described in the report would be the best course of action.

## EXECUTIVE SUMMARY

Council directed that loan options with performance standards for a \$1 million loan to the REP be developed for Council consideration. Four options are submitted, including one from the REP. The loan proposals were reviewed by the Fiscal Corrective Team on September 8. In addition to the four options, specific loan conditions have been prepared that were reviewed with the REP. The REP concurs with all of the loan conditions and requirements. If a \$1 million loan is approved, an appropriation from the General Fund will be required. As the loan is repaid, it is recommended that the money be placed into an Arts Stabilization Fund that can be used to assist non-profits

The City Auditor has reviewed the fiscal assessment report prepared by a consultant that was funded by the Hewlett Foundation. His office has also reviewed five years of audited financial statements, reviewed financial records at the offices of the REP and interviewed numerous REP representatives and foundation representatives. Key pieces of financial information gathered so far include:

- REP has more than \$450,000 in outstanding accounts payables, of which more than ½ are 90 days past due. Consequently, many of the vendors are requiring cash for the purchase of goods and services.
- REP has an \$842,000 letter of credit that can be called at any time by the bank. Interest only payments are being made monthly in the amount of \$5,000. The bank required security for the letter of credit, so a \$600,000 endowment held by the Community Foundation was transferred to fulfill this requirement. Auditor is in the process of confirming that appropriate approvals were obtained to transfer these funds from an endowment to serve as security for a line of credit.
- Auditor is waiting for documentation from the REP that use of two restricted endowments, each at \$1 million or more were properly authorized for converting to make debt payments and to pay for operations.
- Revenue forecasts from contributed income (individual donors and corporations) seem to be aggressive. The historical information does not support revenue forecasts at this level.
- Although the REP has stated its commitment to strengthen its operations in the finance and budget areas, there isn't the capacity of current staff to carry out the recommendations contained in the fiscal assessment study funded by the Hewlett Foundation. There is only a part-time-Finance Director and the Controller has little experience in this field.

The City Auditor will submit a report later this week for the September 19 agenda that more completely describes the above, as well as other findings. The Auditor will have a complete report for the September 26 meeting.

## **BACKGROUND**

On August 29, the City Council directed the City Manager to "Return to the September 12 City Council meeting with a menu of loan options with clearly defined performance standards to keep the SJ Rep in operation for the remainder of Fiscal Year 2006-07 (September 1, 2006 through August 31, 2007). On August 30, the Rules Committee approved extending the date for bringing back the loan options to September 19.

In addition, other directives were approved at the same time. They were:

1. "Form a corrective fiscal team. Direct the team to join with the San José Repertory Theatre and the appropriate foundations to produce a concrete plan to correct infrastructure problems at the non-profit and ensure its long term financial stability. The team shall include, but not be limited to a representative from each of the following: Office of the City Manager, Office of the Finance Director, Office of Cultural Affairs and Councilmember Forrest Williams, City Council Liaison to the San José Arts Commission." Steve McCray, Chair of the Arts Commission has been added to the team. REP representatives will also participate in the Team. The City Auditor will attend as a resource to the Team.

The corrective fiscal team held its first meeting on Friday, September 8 to review loan options. Though the foundations remain committed to working with the SJ Rep, they asked to stay in contact with the Team as it progresses in its work, but opted not to participate as a member. Councilmember Forrest Williams was absent, as he was on City business in England. None of his staff was available to attend in his stead.

The "Team" will continue to meet to be updated on the progress of the REP's implementation plan for restructuring the organization. The "Team" will meet to review the REP's monthly financial reports and the bi-monthly reports from the consultant who will be engaged to assist the REP in implementing its restructuring plan.

2. In addition to bringing back a menu of loan options to keep the REP in operation for the fiscal year, Council also directed that staff look at business reorganization, creation of a new organization and evaluation of the debt. The City Auditor assumed the responsibility for responding to this directive. As mentioned earlier in this report, the Auditor will submit a report under separate cover for the September 19 meeting and a full report for the September 26 meeting.
3. "Establish a monthly review of the REP's progress and report to the Corrective Fiscal Team." Each of the loan options provides for financial review and monitoring, including monthly financial reports as one of the loan conditions. These will be reviewed by the Team and is described above under item #1.
4. "Create a "best practices" standard for City interaction with nonprofits in crises, utilizing lessons learned with the REP and report progress to the Council through the Driving Strong Economy Committee." Work was started in March of this year with an interdepartmental team as a result of the Grants Management Audit to better coordinate and strengthen the City's financial review and oversight of all non-profit organizations. The experiences with several non-profits, including the REP, have made staff keenly aware of the importance of ongoing financial review and monitoring of each of the non-profits that is funded by the City, regardless of funding source. It is anticipated that the determination of "best practices" as they relate to dealing with crises will be completed within 30-60 days. "Best practices" as they apply to the entire process of evaluating proposals, monitoring non-profits with a specific "check list" is a longer-term and comprehensive effort. A workplan is currently being developed. Reports will be submitted to the Driving Strong Economy Committee.

## ANALYSIS

Based on reviews of the financial assessment report prepared for the Hewlett Foundation, audited financial statements for the past five years, and review of the annual budgets, the REP has experienced fiscal and organizational problems for some time. Its problems will not be solved with a one-time bailout – the bailout will, however, allow the organization to continue to operate for a period of time while major re-tooling continues. Although the REP has made progress in making a number of organizational changes, the organization acknowledges that its long-term viability is predicated on developing and implementing a workplan for major restructuring. This effort will be led by a consultant and the Foundations have expressed interest in and willingness to fund this effort. The foundations have stressed to staff that implementing the workplan for restructuring is absolutely critical.

Loan conditions and requirements have been established. The loan options are as follows:

1. No loan.
2. One year loan with monthly payouts; principal and interest due at the end of the year.
3. Five year loan with monthly payouts up to one year or until the \$1 million is exhausted, whichever occurs first; payments on principal deferred to the end of year 3 to be paid in three installments. All interest, which is charged annually for the loan period, will be paid at the end of year 5. This is the staff preferred option, subject to completion of review by Auditor.
4. Fifteen year loan with funds disbursed in lump sum; no payments due until year 6, at which time the loan is amortized over a 10 year period. This is the REP's option.

### **City's Loan Conditions**

The loan requirements were prepared by the Finance Department, except for #1, which was prepared by OCA. Each of these was discussed at the Corrective Fiscal Team meeting on September 8. The REP agrees with all of the conditions described below.

1. The REP finalizes a workplan with an independent management consultant or consultants by October 23 for a comprehensive restructuring of the REP, and secures by that date, a commitment to provide financial support for the consultant's fees from at least 2 of the group of foundations with which the REP has been discussing its organizational crises since January 2006. The REP provides the City with a copy of the workplan and executes a contract with the management consultant by October 31 for implementation of the workplan. Implementation is to begin by January 1, 2007. The REP provides City a monthly program report on the progress of implementing the workplan.
2. During the loan term, the REP submits audited financial statements to the City within five months from the end of the fiscal year for 2005-06 and annually thereafter, three months after the end of each fiscal year. (REP is in the process of completing a process for selecting an audit firm, necessitating a longer-time period for completing the financial audit in year 1 of the loan agreement.)
3. During the loan term, the REP submits an annual budget to the City one month prior to the beginning of each fiscal year (August 1, since fiscal year begins September 1). A five-year financial capacity plan accompanies the submittal and Year 1 of the five-year plan ties to the annual budget.
4. Effective with the execution of the loan agreement, the REP submits each month, a balance sheet and income statement in a 12-month format showing actual results to date and projected future results. These financial reports are due two weeks after the month end. Prior to submitting the monthly financial reports, REP and City staff will meet to discuss drafts of the financial reports to provide City with an opportunity to clarify information and data prior to receiving the monthly reports.
5. If there are unfavorable budget to actual variances of 10% or more for total sources, uses and ending cash balance amounts appearing on the monthly financial reports, REP will submit written explanation and provide corrective action plan.

6. The City's loan is subordinate to existing REP debt where the debt agreement states that the debt has primary status. Therefore, all debt issued by the REP after the City loan must be subordinate to the City Loan.
  
7. Additional recommendations that may come from the Auditor's findings.

**LOAN OPTIONS**

<b>Description</b>	<b>Option 1</b>	<b>Option 2</b>	<b>Option 3</b>	<b>Option 4</b>
<b>Principal</b>	<b>No Loan</b>	<b>\$1,,000,000</b>	<b>\$1,000,000</b>	<b>\$1,000,000</b>
<b>Term</b>	<b>No Loan</b>	<b>1 year</b>	<b>5 years</b>	<b>15 years</b>
<b>Interest</b>	<b>No Loan</b>	<b>Monthly</b>	<b>Annual with deferred payment</b>	<b>None for first 5 years, annually thereafter</b>
<b>Payout</b>	<b>No Loan</b>	<b>Monthly to cover need until \$1 M is disbursed</b>	<b>Monthly to cover need until \$1 M is disbursed</b>	<b>Immediate lump sum</b>
<b>Payback Principal</b>	<b>No Loan</b>	<b>Paid in full at end of one year</b>	<b>Deferred to installments at end of years 3, 4, 5, including interest at end of year 5</b>	<b>Annual payments each of the last 10 years of loan</b>

**Option 1: No Loan**

The REP has already embarked on making changes by implementing recommendations from reports commissioned by the Foundations. The Rep has also committed to reinventing itself by engaging the services of a management consultant to implement significant restructuring of the organization. The restructuring includes revamping the artistic vision to reflect fiscal reality, putting in place new governance and oversight responsibilities for the Board, permanently revamping the REP's budget so that it can live within its means and carry out a debt reduction program. The REP will not be able to continue these efforts and remain open for the next year without a City loan, based on staff's review of financial reports.

**Option 2: One Year Loan**

Under this option, the \$1 million would be disbursed monthly until the full amount is expended. or for one year, whichever comes first. The monthly amount would be predicated on financial projections provided by the REP to allow the organization to meet its expenditures plus an amount sufficient to maintain a \$50,000 cash balance.

Principal and interest would be paid to the City at the end of the one-year loan agreement. The maximum interest rate would be set at the rate the City earns on its investments for that year. This option most closely meets the directive of the Council for a short-term loan that keeps the REP in operation for the current fiscal year. The REP submitted a 12-month cash flow showing an infusion of a \$1 million loan from the City. A recent cash flow projection showed a balance of

approximately \$1.3 million at the end of the year. Repaying the City immediately at the end of the one-year agreement would leave the REP without any working capital or reserves. Additionally, we believe that some of the revenues (contributed income from donors and corporations) are aggressive. This would likely cause the REP to return to the City for additional financial assistance

### **Option 3: Five Year Loan**

Under this option, the \$1 million would be disbursed monthly until the full amount is expended. Cash flow projections from the REP show that the \$1 million would be disbursed in one year. The payout plan is identical to Option 2. However, principal and interest payments would be deferred until the end of year 3. At that time, principal payments would be made in annual installments over a three-year period with interest deferred to a lump sum at the end of year 5. The interest would be charged each year with maximum interest rate calculated on the City's interest on its investments, averaged each year.

If the Council makes a decision to proceed with a loan after being presented with the financial analysis and findings from the City Auditor, this is staff's preferred option because in addition to providing assistance to allow the REP to operate during the fiscal year, it gives the organization a reasonable period of time to implement additional retooling of its artistic mission, board governance and oversight roles and to live within its budget. This should place the organization in a stronger position to pay back the debt and still enable it to be successful artistically and establish a solid financial base.

### **Option 4: 15 Year Loan (Proposed by the REP)**

Under this option, the \$1 Million would be paid out immediately in one lump sum. Payments on principal and interest would be deferred to the beginning of year 6, after which there would be equal payments each year. The interest rate would be 5%.

This option provides a relatively long period of time before the loan is paid off. The REP proposed this option because it will facilitate paying off some of its other debts, and begin building a reserve.

Staff does not recommend this option because of the length of the loan period. More importantly, it does not provide rigorous monthly review of expenditures and revenues prior to disbursing any of the loan funds, as the funds are disbursed immediately in a lump sum.

### **Establishment of an Arts Stabilization Fund**

It is recommended that an Arts Stabilization Fund be established. All principal and interest payments on loans to arts organizations will be deposited into this fund to be used to assist non-profits. The funds could be used for a number of purposes, including: consultant assistance to assist an organization to improve its financial health, short-term loan to fill a funding gap, etc.

### **PUBLIC OUTREACH/INTEREST**

- √ **Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
  
- **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

### **COORDINATION**

The substantive information in this report has been coordinated with Budget, Finance, Office of Cultural Affairs, and the City Attorney's Office. The REP is aware of staff's recommendation to defer decision on consideration of a loan until September 26, when the Auditor submits a complete report. A separate progress report on the work completed to date by the Auditor will be submitted later this week in time for the September 19 meeting. A full report will be distributed to Council for the September 26 meeting.

### **COST SUMMARY/IMPLICATIONS**

The only source for the \$1 million loan is the General Fund. This loan was not planned nor budgeted. If approved, an appropriation will be required.

Another source of funding would be using some or all of the REP's O&M grant and/or its Operating Grant awarded annually through the competitive arts grant process to pay off principal and/or interest. At this time, that would not be financially feasible for the REP. However, if Option 3 is approved and no payments are due until the end of the third year of the loan, some or all of these funds could be used to pay down the loan.

If Council approves any of the options besides #1, the Budget Office will prepare an appropriation to bring back to the Council and the City Attorney's Office will work on the loan agreement between the City and REP.

### **CEQA**

Not a project

  
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