



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Les White

SUBJECT: San José Repertory Theatre
Loan Options

DATE: October 5, 2006

RECOMMENDATION

1. Approval of a \$2 million line of credit for the San José Repertory Theatre (REP) under the following conditions:
 - (a) REP submits a draft business plan on or before December 31, 2006;
 - (b) REP provides written documentation by December 31, 2006 that it will achieve the contributed income projections of approximately \$1.5 million-\$2 million for the current fiscal year;
 - (c) REP complies with all of the terms and conditions of the loan contained in Appendix A of the report; and
 - (d) If approved, adopt a resolution authorizing the City Manager to negotiate and execute a loan agreement with the REP in an amount not to exceed \$2 million.

2. If action is taken to approve the line of credit for the San José Repertory Theatre, either
 - (a) Authorize utilization of the newly-created Arts Stabilization Fund, approved as part of the City Manager's 2005-2006 Annual Report and the associated appropriation ordinance, Item 3.4 on this Agenda; or
 - (b) Adopt an amendment to the annual appropriation ordinance in the General Fund to:
 - (i) Establish an appropriation in City Wide, City Manager's Office; and
 - (ii) Decrease the contingency reserve by \$2 million.

OUTCOME

Provide the City Council with responses to questions raised at the September 19, 2006 meeting regarding the REP's cash flow situation, and the impact of a \$1 million loan on the REP's sustainability. Provide responses to other additional questions raised by the

City Council, including: potential business reorganization efforts; financial implications of possible alliances with Team José; and an update on the continued participation of major foundation funders.

EXECUTIVE SUMMARY

Following the September 19 meeting, the City Auditor assumed the lead, with the Finance Department providing support, to respond to the question of the amount the REP needs to be sustainable for the short and long-term. The Auditor's report provides detail that supports the conclusion that a \$1 million loan is insufficient to sustain the REP on even a short-term basis. Financial assistance of approximately \$2 million is needed to sustain the REP through the current fiscal year and for a second year in order for its new business model to be operational.

BACKGROUND

On September 19, 2006, two reports were presented on the San Jose Repertory Theatre (REP): a report from the City Manager on \$1 million loan options; and a report from the City Auditor on a Financial Assessment of the REP. At the conclusion of discussion on these reports, the City Manager and City Auditor were requested to return to Council with a joint memorandum outlining each of the Auditor's findings, along with the REP's response to each. Also, the question about bankruptcy and reorganization was referred to the City Attorney for response.

Following the September 19 meeting, staff worked with the REP to obtain updated information to respond to Council's questions. The Auditor's report includes a matrix that summarizes the Auditor's findings, the REP's responses, and in some cases, the Auditor's comments on the REP's response.

The Council directed a number of questions for response at the October 17, 2006 meeting. They are as follows:

- How much money does the REP need to be sustainable in the short-term and long-term?
- What impact does each loan option have on the REP's sustainability?
- What are the REP's business reorganization and bankruptcy options?
- What is the legality of using restricted endowment funds to secure the letter of credit?
- What are the implications of business reorganization and bankruptcy on a City loan to the REP?
- If the City provides a loan to the REP, will the bank "call" the line of credit?

- What are the cost implications/savings of a relationship between the REP and Team San José or between the REP and American Musical Theatre?
- Can the City establish a criteria-based framework to assess non-profit organizations requests for financial assistance?

ANALYSIS

How much money does the REP need to be sustainable in the short and long term?

The Office of the City Auditor's memorandum provides specific information on the amount of funds needed to sustain the REP in the short-term and long-term. The Auditor's report concludes that cash infusion of at least \$1.4 million would be required for the current fiscal year (September 1 2006 - August 31, 2007) and that the organization will require an additional \$200-\$500,000 additional cash infusion in fiscal year 2007-2008.

What impact does each loan option have on the Rep's sustainability?

Following detailed discussions with the REP and further review of updated financial information, City staff has concluded that a \$1 million dollar loan in any form is less than the amount necessary to sustain the REP through the 2006-07 fiscal year and will not aid in its efforts to reduce its long-term debt. Rather than \$1 million, the amount required is \$2 million. This will sustain the REP's operations for the current year and provide sufficient cash to enable the REP to operate while its new business model is implemented.

The four loan options that were presented in the September 19 report for \$1 million are summarized below. Since all of the options are no longer feasible based on updated financial information from the Auditor's report, a new loan option has been added: a letter of credit in the amount of \$2 million. Details of the new option are provided below.

Summary of Previous Loan Options

**Option 1:
No Loan**

The REP will be unable to sustain its operations through the end of the 2006-2007 fiscal year unless it develops significant working capital from alternative sources within one to two months from now.

**Option 2:
One Year Loan of
\$1 Million**

This option disburses funds monthly until the full amount is expended. Although previous cash flow projections from the REP showed a \$300,000 surplus by the end of the 2006-07 fiscal year, new projections show that the REP will have a cash flow deficit peak in February 2007 and end the fiscal year 2006-07 with an operating deficit of approximately \$450,000.

Consequently, both the loan amount and repayment period are not feasible.

**Option 3:
Five Year Loan of
\$1 Million**

This option disburses the funds on a monthly basis until the full amount is expended. The only difference between this option and Option #2 is the repayment period on the loan. The REP's cash flow problem in the current year is not addressed in this option. Should its revenues improve, the REP still has significant outstanding debt that must be paid. Unless the REP develops alternative sources of working capital, it is not likely that the organization will be in the position to repay the loan and interest by the end of the 5 year period.

**Option 4:
15 Year Loan of \$1
Million (proposed
by REP)**

This option was proposed by the REP as a lump sum disbursement and no interest for the first five years. Again, the updated cash flow projections indicate that a \$1 million infusion of funds will be insufficient to stabilize the organization. This loan option does not provide the close monitoring and rigorous review of expenditures and revenues recommended by staff.

NEW LOAN OPTION FOR CONSIDERATION

Option 5: \$2 Million Line of Credit for Ten Years

Option 5 is a \$2 million revolving line-of credit with interest paid monthly at the monthly effective yield earned on the City's portfolio. The loan conditions are provided in detail in Appendix A.

- Years 1-5: \$2 million would be available and disbursements would be made on a monthly basis to meet REP's expenditures and provide a \$50,000 cash balance for contingencies. The REP would make interest only payments monthly during this time period.
- Years 6-10: The amount of the revolving line of credit would be reduced by \$400,000 each year and principal and interest payments would be made. By year ten, the line of credit would be eliminated and paid in full to the City.

This option meets the Council's expressed objective of sustaining the REP in the short term and providing an opportunity for fiscal stabilization. It also protects the City's assets by limiting the disbursement to only the amount required by the REP for its operations. The close monitoring and review proposed in Options 2 and 3 above would be retained.

What are the REP's business reorganization and bankruptcy options? What are the implication of business reorganization and bankruptcy on a City loan to the REP? What is the legality of using restricted endowment funds to secure the letter of credit?

The City Attorney's Office issued a separate report to the Mayor and Council dated September 26, 2006 that responded to each of the questions raised by Council. A copy of the report is attached.

If the City provides a loan to the REP, will the bank "call" the line of credit?

According to Comerica Bank officials, the line of credit is payable on demand based on the event of a default. Comerica Bank has no interest in calling the loan or seizing the collateral unless there is an event of default (for example, failure to make interest payments). Further, and most importantly, the loan documents do not allow Comerica Bank to call the loan or seize the collateral unless there is an event of default.

What are the cost implications/savings of a relationship between the REP and Team San José or between the REP and American Musical Theatre?

In its response to the City Auditor's September 18, 2006 report, the REP indicated that there was a possibility that Team San José could assume management responsibility for its facility – maintenance and operations or sales and marketing. However, at that time, the REP had not had the opportunity for any discussions with Team San José. The REP's interim managing director and Team San José held an initial meeting to discuss possible areas of collaboration on October 5, 2006. At this point, it is premature to calculate any cost savings that may result from these discussions.

The REP and AMT continue discussions regarding merger of back-of-office functions. If these materialize, the annual savings to each group could be in the range of \$200-\$300,000 per year. These figures have not been incorporated in the REP's cash flow projections.

Can the City establish a criteria-based framework to assess non-profit organizations' requests for financial assistance?

Staff has already initiated an effort to better coordinate and strengthen the City's financial review and oversight of all non-profit organizations, regardless of funding source. An interdepartmental team has been established and a draft workplan has been developed that will include application criteria and review, performance standards, and ongoing

monitoring throughout the grant period. Implementation of this process and plan is to ensure a "level playing field" for all non-profits applying to the City for financial assistance.

ADDITIONAL ISSUES OF CONCERN

Continued Participation of the Foundations

The REP continues to meet with a group of key foundations to provide financial assistance with efforts to restructuring the organization. On September 20, Tom Hall, principal of Albert Hall & Associates met with key members of the REP's Board of Directors and its interim managing director and representatives of the Irvine, Hewlett and Knight foundations, as well as the City to discuss a possible consultancy effort. Through a review process that the REP undertook several months ago, Tom Hall was selected by the Board to complete this work. The Foundations are aware of Mr. Hall's experience and work and support this selection.

During the meeting, Mr. Hall stated that the REP requires a complete retooling to address not only its financial management systems, but all aspects of the REP's operations, management (financial and artistic) and governance, and the organization's corporate culture. The consultant anticipated that this re-tooling effort would require at least 12 months to develop and implement and another complete business cycle to test it. Consequently, the minimum amount of time it would take for implementation and testing would be two years. A condition of the line of credit is that the consultant completes and submits a draft business plan by the end of calendar year 2006.

A revised proposal was submitted to the REP at the end of last week and the proposal will be forwarded to the Foundation funders during the week of October 2. The Foundation representatives remain interested in assisting the REP, but at this point, no funding commitments have been made. The cost of the consultant's work is not yet finalized; however, no other source of funding has been identified by the REP.

Due to the extreme severity of the REP's organizational and financial crises, the consulting assistance must proceed and the Board and staff of the REP must remain diligent in working with the consultant during the twelve month period while the implementation plan is being developed to follow each step of the plan upon its completion

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 the Budget Office, Finance Department, Office of Cultural Affairs, and the City Auditor's Office. There have been three (3) meetings of the Corrective Fiscal Team that were attended by REP officials. This included the opportunity to review the information in these reports from the Auditor and the City Manager.

COST SUMMARY/IMPLICATIONS

Recent analysis completed by staff of the Auditor's Office and the Finance Department conclude that:

- The REP will end the current fiscal year with a deficit of approximately \$450,000, rather than a \$300,000 surplus that had been previously projected and reported in the September 19 staff report.
- Updated financial information shows that a \$1 million loan will not sustain the organization through the fiscal year. In order for the REP to continue to operate for the remainder of this fiscal year and for an additional year until the new business plan/model have been operational, the Auditor's report states that a minimum of \$1.4 million financial assistance is required for the current fiscal year. In addition, there is a need for an additional \$200-\$500,000 for fiscal year 2007-08. Therefore, financial assistance required for the two-year period is close to \$2 million.
- Due to uncertainties about the REP's sustainability, even with the infusion of City funding, two major conditions have been added: that by December 31, 2006, REP will complete and submit a draft business plan and will also provide documentation that supports that it will achieve \$1.5 – \$2 million in contributed income for the current fiscal year. These conditions are in addition to the oversight and loan conditions included in Appendix A of the staff report.

CEQA

Not a project.


for Les White
City Manager

For additional information, contact Kay Winer, Chief Deputy City Manager at 535-8130

Appendix A

City Oversight and REP Loan Conditions

1. Restructuring Workplan

- The REP finalizes a work plan 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 work plan and executes a contract with the management consultant by October 31 for implementation of the work plan.
- Consultant will be on site to initiate work beginning November 2006.
- The REP provides City a monthly program report on the progress of implementing the work plan.

2. Audited Financial Statements

- During the loan term, the REP submits audited financial statements to the City's Director of Finance annually, as follows:
 - Within five months from the end of the fiscal year for 2005-06 (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, and;
 - Annually thereafter, three months after the end of each fiscal year during the loan term.

3. Annual Budget

- During the loan term, the REP submits an annual budget to the City's Director of Finance one month prior to the beginning of each fiscal year (August 1, since fiscal year begins September 1).
- Each year during the loan term the REP shall provide the City with a five-year Financial Capacity Plan (FCP) along with the annual budget. The FCP shall accompany the budget submittal and Year 1 of the FCP shall tie to the annual budget.

4. Monthly Financial Reports

- Effective with the execution of the loan agreement, the REP shall submit the following monthly reports to the City's Director of Finance within two weeks following the preceding month end;
- balance sheet,

- income statement (showing annual budget, actual year-to date, monthly budget and monthly actuals and variances between budget and actual),
- 12-month rolling cash flow schedule (using a 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. Variance report and Conditions

- If there are unfavorable budget to actual variances of 10% or greater for total year-to-date amounts appearing on the monthly cash flow reports in any of the following categories;
 - sources (cash receipts), or
 - uses (cash disbursements), or
 - ending cash balance, then
- REP will submit written explanation and provide corrective action plan to City's Director of Finance.
- If the City is not satisfied with the corrective action plan, the City's Director of Finance may discontinue advances to the REP and the City may call the loan (or line of credit balance outstanding) due and payable, in full (principal and interest), within thirty days (30 days) of written notice from the City to the REP.

6. Subordination of City's Loan

- The City's loan is subordinate to existing REP debt where the debt agreement states that the debt has primary status.
- City's loan proceeds may fund REP's interest payments on existing loans; however such City loan proceeds shall not fund principal payments on existing REP debt.
- In addition, any and all debt incurred by the REP after the date of execution of the City loan must be subordinate to the City Loan.

7. Working Capital Requirement

- The City will advance funds to the REP sufficient to meet disbursement needs and provide a \$50,000 month-end working capital cash balance for contingencies.
- If the REP's monthly ending cash balance after meeting monthly disbursement needs exceeds \$50,000, the REP will pay the excess back to the City and such amount will become available for future advances (not to exceed the available loan amount).

8. City Serve as Ex-Officio Member

- A City representative will serve ex-officio on the REP's Board of Directors and its Audit and Finance Committees. The City Manager may choose to appoint a different City staff member to each role.

9. Cancellation Provision

- The City may, at any time, cancel the loan and call its balance to be repaid by REP in the event the REP violates or does not meet any of the terms and conditions of the loan agreement.