COUNCIL AGENDA: 10-31-06
ITEM: 4.3

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

REPLACEMENT

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Kay Winer

SUBJECT: **AMERICAN MUSICAL THEATRE OF SAN JOSÉ LINE OF CREDIT**

DATE: 10-13-06

Approved _____ Date 10-17-06

Council District: City-Wide

REASON FOR REPLACEMENT

There is a typographical error on page 3 of the staff report: **Summary of Events that Led to Current Financial Situation.** In the second bullet point on the second line, the revenues should be stated as $11.3 million, not $1.3 million. Please discard the previous report distributed on October 16 and replace with this one.

RECOMMENDATION

1. Approve a $1 million revolving line of credit for the American Musical Theatre of San José (AMTSJ) under the following conditions:
   (a) AMTSJ complies with all of the terms and conditions of the loan agreement contained in Appendix A of this report; and
   (b) If approved, adopt a resolution authorizing the City Manager to negotiate and execute a loan agreement with AMTSJ in an amount not to exceed $1 million.

2. If action is taken to approve the line-of-credit for AMTSJ, either
   (a) Authorize utilization of the newly-created Arts Stabilization Fund, if approved as part of the City Manager's 2005-2006 Annual Report and the associated appropriation ordinance, Item 3.4 on the October 17, 2006, City Council 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 $1 million.

OUTCOME

Extending a revolving line-of-credit in the amount of $1 million for a five (5) year term will allow the American Musical Theatre of San José (AMTSJ) to continue its 2006-07 season and to transition to a new business model that positions the organization for long-term stability. AMTSJ is the major tenant at the Center for the Performing Arts (CPA), which generates significant revenue for Team San José, and is an integral part of the economic development of the downtown. The line of credit will also allow the opportunity for AMTSJ to complete, as part of its new business model, cost saving measures such as consolidation of office functions, ticketing, etc., with other non-profit San José arts organizations.

EXECUTIVE SUMMARY

The AMTSJ's executive staff notified the City Manager's staff and City Council in late August and early September 2006 that their financial picture had changed dramatically, exacerbated by situations that occurred in June and July 2006. Consequently emergency funding is required to keep the organization active through the 2006-07 season and into a period that allows for the implementation of a new business model. Though AMTSJ had taken major steps to reduce costs, some of these could not be realized immediately. AMTSJ indicated that without City support, the company would need to cancel its holiday show and essentially shut down, while other options were being considered. AMTSJ submitted its new business model, cash flow projections, audited financial statements for the past five years, as well as other information for staff's review.

After careful review of AMTSJ's financial records, as well as on-site meetings with AMTSJ staff, the Auditor's Office concluded that a $1 million loan is the amount required and AMTSJ appears to have the capacity to repay interest on an ongoing basis and to pay off the principal in its entirety by the end of year 5.

A report from the Auditor's Office will be distributed separately.

BACKGROUND

City Made Aware of AMTSJ Emergency in August/September Timeframe

Beginning in late August, AMTSJ executive staff notified the City Administration and the City Council of their financial situation that was made worse as a result of events that occurred earlier that summer. As a result, staff from the City Manager's Office and the Office of Cultural Affairs met with board members and key staff to better understand the events leading to the critical shortfall. At the conclusion of the meeting, AMTSJ was asked to prepare a specific request to the City. This was followed by a September 5, 2006 letter to the City Council requesting a ten

year, no-interest loan of $1 million. Additionally, AMTSJ requested that the City consider purchasing the sound system that the company had just recently bought and installed at the Center for the Performing Arts in the amount of $470,000 not only for use by AMTSJ, but for all other renters of the facility that contract with Team San José. This item was recommended for purchase in the City Manager's Annual Report, which will be considered by the City Council on October 17.

The City Manager's Office requested the assistance of the City Auditor to review the financial information and on September 20, the Rules Committee approved adding the AMTSJ financial analysis to its workload. Staff from both the Administration and the Auditor's Office have been in continuing contact with AMTSJ at scheduled meetings, and visits from the Auditor have taken place at AMTSJ's office in order to conclude the financial analysis.

Summary of Events that Led to Current Financial Situation

AMTSJ has been in existence for over 70 years and has never approached the City for emergency financial assistance.

- In FY 2000-01, a large new works venture failed financially that eliminated a $1.1 million unrestricted surplus that AMTSJ had managed to build up over the years.
- AMTSJ ended the FY 2003-04 season with an unprecedented net loss of almost $2.8 million on revenues of about $11.3 million, far more than could be managed with its Silicon Valley Arts Fund reserves held by the Community Foundation of Silicon Valley. In order to meet its cash needs, AMTSJ spent a substantial portion of its advance subscription renewal income that should have been reserved for the following year's production costs.
- Through a combination of cost cutting of more than $2 million in non-production expenses and a 50% increase in its fundraising over the previous year in the amount of $500,000, AMTSJ managed to end FY 2004-05 with an unrestricted gain of $545,000. However, this was not sufficient to replace the advance subscription revenues that had been spent prematurely. AMTSJ ended FY 2005-06 with another $500,000 loss.

AMTSJ"S Major Shifts to Eliminate Systemic Financial Losses

- **Board Role Redefined:** As a Board member, fundraising is a major commitment that each must make in his/her capacity as a Board member. Due to the fact that earned income has traditionally been very high (as much as over 95% of the budget), fund raising has not been emphasized as a key requirement for serving on the Board. Now that the new business model shows a balance of 80% earned revenue to 20% contributed revenue, the role of fundraising has been elevated.

- **Termination of Agreement with the Nederlander Organization:** AMTSJ formalized a contractual relationship with Nederlander for a five-year term. Nederlander is one of the nation's largest producers and promoters of Broadway musicals. Though Nederlander

was interested in expanding its presence in the Bay Area, particularly in the South Bay, this alliance did not meet AMTSJ's expectations.

- Since Nederlander owns three major theaters in San Francisco, it steered the best shows there. The shows that were presented in San José tended to arrive only after extended runs in San Francisco, leaving an insufficient number of patrons willing to pay the high ticket prices that the show producers demanded.
- Nederlander acted as AMTSJ's booking agent, which is unprecedented in the industry. In this capacity, Nederlander was paid show-by-show, a separate negotiated profit and loss statement. Due to this touring model, AMTSJ was unable to discount tickets, thus leaving a major shortfall in earned revenues.

- AMTSJ's management, appointed at the end of the 2003-04 season, began negotiations to terminate the Nederlander contract and succeeded in terminating the agreement, effective June 30, 2006. Due to a 12-18 month lead time for booking shows, AMTSJ was forced to book the FY 2006-07 season before beginning to embark on the new business model.

ANALYSIS

New Business Model

A major underlying assumption is that the company will be more likely to be sustainable by returning to its self-producing roots, but with a strong focus this time on sharing the cost of productions by collaborating frequently with other regional musical theaters throughout the country. AMTSJ proposes to further control costs by reducing the number of shows per season from nine to five, relying more heavily on actors from the Bay Area, and taking a number of measures to reduce overhead expenditures. The latter includes discussions with San José Repertory Theatre regarding possible efficiencies by combining certain production operations, such as scene and costume shops.

The company plans to launch its new business model with the 2007-08 season. As a transition during the 2006-07 season, AMTSJ continues to offer a combination of touring and self-produced shows. However, without the constraints of the Nederlander contract that ended with the 2005-06 season, AMTSJ has been able to make its own selection of touring shows and it has been able to scale back the overall number of shows in the season, thereby contributing to a significantly lower expense budget this year.

Without working capital, however, AMTSJ will not be able to complete the current season and make its transition to its new business model. The company has pinpointed its working capital needs as an additional $1.25 million dollars. It has secured commitments from Board members for $200,000, and believes that it has strong leads on an additional $50,000 from individuals or their businesses.

Loan Options

Staff evaluated a variety of loan options that included "No Loan" to the preferred option submitted by the AMTSJ, which is a no interest, 10-year loan. As a result of the Auditor's analysis and staff review of their business model, a five-year revolving line of credit is recommended. The Auditor believes that the terms and conditions of a five-year line of credit can be met by AMTSJ; similarly, AMTSJ is confident that these terms and conditions can be fulfilled and concurs with this loan option.

Summary of Five Year Line of Credit for $1 Million

- For years 1 and 2, only interest is paid at the rate of the City's earnings on its investments. The interest is calculated monthly and paid annually.
- Beginning in year 3, payments on principal and interest will be required, with the line of credit fully retired by the end of year 5. Specific conditions and terms of the five-year revolving line of credit are provided in Appendix A, following this report.

POLICY ALTERNATIVES

Alternative #1: One alternative would be not to approve a line-of-credit to the AMTSJ to assist in its survival through difficult economic times.
Pros: Not approving the line-of-credit would require the organization to endeavor to survive on its own, without public assistance. Public funds requested could be reserved for other City priorities.
Cons: Not approving this action could result in AMTSJ not surviving into this 2006 holiday season.
Reason for not recommending: AMTSJ has provided concrete plans for its financial recovery and stabilization. The organization has provided the community with arts offerings for over seventy years and has proven that it provides positive economic impact to the downtown.

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)**

This project hits the $1 million threshold for Criteria 1 and accordingly this memo is posted on the City's website for the October 24, 2006 Council Agenda.

COORDINATION

The substantive information in the memorandum has been coordinated with the City Attorney's Office, the Office of Cultural Affairs, the City Manager's Budget Office, the Finance Department and the City Auditor's Office. AMTSJ has had an opportunity to review the report and concurs with the recommendation.

FISCAL/POLICY ALIGNMENT

Supporting the AMTSJ as it continues restructuring and stabilization efforts aligns with two (2) of the San José Economic Development Strategies, a "Creative Community, item 4. Evolve and Position Downtown as a Unique and Cultural Center of Silicon Valley, and World's Most Livable Big City item 12. Encourage Sporting Teams, Events, and Facilities, Professional as well as Amateur."

The AMTSJ has been a major part of the local arts scene for 72 years, is currently the largest tenant in the CPA, and has had positive economic impact on the downtown and the local community. It has developed a new business model and marketing plan that indicate that AMTSJ has the necessary ability to refocus, to re-structure and to continue developing professionally while serving the community.

CEQA

Not a Project.

Kay Winer

KAY WINER
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APPENDIX A

City Oversight and AMTSJ Revolving Line-of-Credit Conditions

1. **Audited Financial Statements**
   - During the loan term, AMTSJ submits audited financial statements to the City's Director of Finance annually within three months after the end of each fiscal year during the loan term, beginning with FY 2006–07.

2. **Annual Budget**
   - During the line-of-credit term, AMTSJ submits an annual budget to the City's Director of Finance one month prior to the beginning of each fiscal year (July 1).
   - Each year during the line-of-credit term, AMTSJ shall provide the City with a five-year Financial Capacity Plan (FCP). The FCP shall accompany the annual budget submittal, and Year 1 of the FCP shall tie to the annual budget.

3. **Monthly Financial Reports**
   - Effective with the execution of the line-of-credit agreement, AMTSJ 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 actuals)
     - 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, AMTSJ and City staff will meet to discuss drafts of the financial reports to provide the City with an opportunity to clarify information and data prior to receiving the monthly reports.

4. **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
   - AMTSJ 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 AMTSJ 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 AMTSJ.

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

6. **Working Capital Requirement**
   - The city will advance funds to the AMTSJ sufficient to meet disbursement needs and provide a $50,000 month-end working capital cash balance for contingencies.
   - If AMTSJ's monthly ending cash balance after meeting monthly disbursements needs exceeds $50,000, the AMTSJ will pay the excess back to the City and such amount will become available for future advances not to exceed the available revolving line-of-credit limit.

7. **City Serve as Ex-Officio Member**
   - A City representative will serve ex-officio on AMTSJ's Board of Directors and as a member of its Finance Committee. The City Manager may choose to appoint a different City staff member to each role.

8. **Cancellation Provision**
   - The City may, at any time, cancel the line-of-credit and call its balance to be repaid by AMTSJ in the event the AMTSJ violates or does not meet any of the terms and conditions of the agreement.