COUNCIL/AUTHORITY AGENDA: 10-21-08
ITEM: 3.6

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson
Jennifer A. Maguire

SUBJECT: SEE BELOW

DATE: October 2, 2008

Approved [signature] Date 10/5/08

COUNCIL DISTRICT: Citywide

SUBJECT: CONSIDERATION OF ACTIONS RELATED TO THE DISPOSITION OF THE COMERICA BANK LINE OF CREDIT FOR THE HAYES MANSION CONFERENCE CENTER

RECOMMENDATION

It is recommended that the City Council adopt the following Appropriation Ordinance amendments in the General Fund to pay the City's outstanding loan with Comerica Bank related to the Dolce Hayes Mansion operations:

a. Decrease the Hayes Mansion Conference Center Line of Credit Security Earmarked Reserve by $5,000,000; and

b. Establish a City-Wide appropriation for the Hayes Mansion Conference Center Line of Credit Payment in the amount of $5,000,000.

OUTCOME

Approval of this recommendation will allow for the repayment of the outstanding principal in the amount of $5.0 million payable under the Loan Agreement between the City of San José and Comerica Bank, as amended, related to the Dolce Hayes Mansion operations (the "Comerica Line of Credit").

BACKGROUND

On October 21, 2003, Council authorized the City Manager to negotiate and execute a $5.0 million line of credit and a $2.0 million term loan agreement with Comerica Bank ("Comerica") related to the transition of the operation and management of the Hayes Mansion from the City's lessee, Hayes Renaissance L.P., to Dolce International/San Jose, Inc. ("Dolce"). Dolce assumed operation of the Hayes Mansion as of January 1, 2004. The line of credit was obtained to fund Hayes Mansion operating cash flow needs and the City's Hayes debt service costs if operating profits were not sufficient. The term loan was obtained to fund the assumption of the former lessee's bank loans.

On October 21, 2003, the City Council also adopted Ordinance No. 26999 which appropriated $5.0 million in the General Fund for the "Hayes Mansion Conference Center Line of Credit Security Earmarked Reserve." This was established pursuant to the requirements of the Comerica loan agreement in the event that the Hayes Mansion revenues were insufficient to repay the principal on the line of credit.

Per Council authorization, on October 30, 2003, a loan agreement for the term loan and line of credit was entered into between the City and Comerica. The term loan included fully amortized monthly payments of principal and interest with the final payment due on October 29, 2007. The City made this final payment on October 29, 2007. Terms of the line of credit include monthly payments of interest only and a commitment expiration date ("maturity date") of October 29, 2007. The loan agreement for the line of credit also contained a provision that allowed for the term to be extended for a period of one year, if requested by the City and approved by Comerica. On October 23, 2007, the City Council adopted a resolution authorizing the Director of Finance to negotiate and execute the First Amendment to the Loan Agreement to extend the maturity date of the line of credit by a period of one year from October 29, 2007 to October 29, 2008. The extension was executed on October 26, 2007.

The $5.0 million Comerica line of credit was fully utilized as of May 2006. The financial condition of the Dolce Hayes Mansion, however, has improved significantly during the last four fiscal years as Dolce increased annual revenue by 43% from $10.5 million to $15.0 million. The increase in revenue is due to the annual occupancy rate increasing from 37.76% to 53.29%, reflecting an increase of 41% over the last four fiscal years, and the average annual daily room rate increasing from $122 per night to $148 per night, far outpacing any inflationary adjustments.

However, cash flow has not been sufficient to pay down the principal on the line of credit. As a result of the shortfall in cash flow, the Dolce Hayes Mansion operation has been receiving an annual operating subsidy from the General Fund which is primarily used for debt service, including bond debt and interest on the Comerica Line of Credit. The General Fund operating subsidy budgeted for Fiscal Year 2008-2009 is $4.1 million.

ANALYSIS

As mentioned above, the Comerica loan contains a provision that allowed for the term to be extended for a period of one year, if requested by the City and approved by Comerica. On August 18, 2008, in response to the City's request to extend the loan agreement, Comerica presented a proposal to either extend the line of credit maturity date for a period of one year to October 29, 2009 or convert the line of credit to a three or five-year term loan. Comerica proposed two variable interest rate options for either extending the line of credit or converting to a term loan which is summarized below:

Comerica Bank Term Sheet		
Rate Option	**Formula**	**Estimated Rate as of 7-10-08**
Prime Option	Variable rate equal to Comerica's Prime Rate minus 0.20% (accrued and charged monthly to Borrower's checking account). As of 7-10-08, Comerica's Prime Rate was 5.00%, yielding an initial rate to borrower of 4.80%. Interest rate to be adjusted <u>any time</u> that Comerica's Prime Rate is changed.	4.80%
Adjustable Rate Option	30-day LIBOR plus 1.71%, to be adjusted monthly (accrued and charged to Borrower's checking account). Borrower to have the option to enter into an Interest Rate Swap, at any time during the term of the loan, that would effectively fix the interest rate over the term of the loan. As of 7-10-08, the effective interest rate paid by Borrower under an Interest Rate Swap would be either 5.16% (36 month term) or 5.52% (60 month term).	5.16% (36 month term) 5.52% (60 month term)

Both variable interest rate options proposed by Comerica are not as favorable as the current options available under the line of credit. The proposed rates are structured to be about 1.0 percentage point higher than currently available. As an example, the current Prime Rate margin is minus 1.25% (compared to the term sheet offer of minus 0.20%) and the current LIBOR margin is plus 0.75% (compared to the term sheet offer of plus 1.71%). Based on the more costly margins offered by Comerica, staff explored other options that are considered more favorable to the City.

In an effort to reduce the debt service of the Hayes Mansion and, therefore, reduce the annual subsidy from the General Fund, staff recommends paying off the Comerica loan using the appropriated reserve. Assuming that the current economic crisis does not negatively impact the hotel and conference center market and therefore reduce revenue generation for the Dolce Hayes Mansion, by paying off the outstanding loan, staff anticipates a reduction of the General Fund subsidy of approximately $150,000 for Fiscal Year 2008-09 and approximately $200,000 for Fiscal Year 2009-2010.

POLICY ALTERNATIVES

Alternative #1: Refunding Comerica Line of Credit with Commercial Paper (CP) Notes
Pros: Amortizing CP Notes over a 7-year term would increase the annual cash flow needs of the Dolce Hayes Mansion by a net amount of $600,000 (net of the interest already being paid on the

Comerica line of credit) and projections indicate a net present value of approximately $1.3 million assuming the CP Notes are retired after 7 years and the $5.0 million Hayes Mansion Conference Center Line of Credit Security Earmarked Reserve is maintained by the City in an interest bearing account for at least 20 years.
Cons: The issuance of CP Notes would increase the General Fund subsidy by up to $600,000 to cover the debt service of the CP Notes.
Reason for Not Recommending: This alternative recommendation would increase the General Fund structural deficit starting Fiscal Year 2009-10 by up to $600,000 to cover the annual debt service of the CP Notes.

Alternative #2: Accept the Comerica Line of Credit Extension
Pros: The City is expected to earn approximately $173,000 in investment of the $5.0 million reserve through the City's investment pool with an assumed budgeted investment pool rate of return of 3.4% between October 29, 2008 and October 28, 2009.
Cons: The City would pay an expected increased net cost of approximately $80,000 for covering the interest payment of the line of credit extension between October 29, 2008 and October 28, 2009.
Reason for Not Recommending: Assuming the selection of the prime rate option under the line of credit extension, the interest rate for the extension period of October 29, 2008 through October 28, 2009 is projected to be 5.05%, which exceeds the projected investment earnings rate on the $5.0 million reserve. Total interest paid to Comerica for the one-year extension is projected to be $253,000, compared to projected investment earnings of $173,000 on the reserve.

PUBLIC OUTREACH/INTEREST

☒ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

☐ **Criterion 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)**

☐ **Criterion 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 item meets Criterion 1. Therefore, the memorandum will be posted on the Council Agenda for the October 21, 2008 Council meeting.

COORDINATION

This report was prepared in coordination with the City Attorney's Office.

COST SUMMARY/IMPLICATIONS

Using the Hayes Mansion Conference Center Line of Credit Security Earmarked Reserve to repay the outstanding principal on the Comerica line of credit will generate annual interest expense savings and potentially result in annual General Fund subsidy reductions of approximately $200,000.

BUDGET REFERENCE

The table below identifies the fund and appropriation proposed to pay the City's outstanding loan with Comerica Bank related to the Dolce Hayes Mansion operations recommended as part of this memorandum.

Fund #	Appn #	Appn. Name	Total Appn	2008-2009 Adopted Operating Budget (Page)	Last Budget Action (Date, Ord. No.)
001	8034	Hayes Mansion Conference Center Line of Credit Security Earmarked Reserve	$5,000,000	IX-32	N/A

CEQA

Not a project.

SCOTT P. JOHNSON
Director of Finance

JENNIFER A. MAGUIRE
Budget Director

For questions, please contact Scott P. Johnson, Director of Finance, at (408) 535-7000.