



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Kim Welsh
Julia H. Cooper

SUBJECT: AMENDED LINE OF CREDIT
AGREEMENT WITH THE SAN
JOSE REPERTORY THEATRE

DATE: October 11, 2011

Approved

Date

10/11/11

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

It is recommended that the Council authorize the City Manager to negotiate and execute an agreement to restructure the existing \$2,000,000 revolving loan Line of Credit Agreement with the San José Repertory Theatre and convert it to a \$2,000,000 Term Loan Agreement to be repaid with interest on or before April 1, 2037.

OUTCOME

The conversion of the revolving loan Line of Credit Agreement (LOC) with the San José Repertory Theatre (Rep) to an extended Term Loan Agreement (Agreement) will result in a higher probability of repayment to the General Fund and improved financial sustainability of the Rep.

BACKGROUND

The Rep, a nonprofit organization that produces award-winning professional theater performances for 75,000 visitors annually, is an important economic and cultural anchor in the downtown area. The Rep's annual impact to the San José economy is estimated at \$9,100,000, according to a 2011 independent economic impact assessment conducted by Deloitte.

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Current Line of Credit Agreement

Recognizing both the economic and cultural benefits of the Rep, when the Rep was experiencing a fiscal crisis in October 2006 and the Council sought to retain its operations, the Council approved a 10-year agreement with the Rep to provide a \$2,000,000 LOC in the form of a revolving loan. Per the current agreement, on October 31, 2011, the amount of the LOC available to the Rep to draw down upon drops from \$2,000,000 to \$1,600,000, requiring the Rep to make a payment to the City for the amount drawn over \$1,600,000. The LOC will drop by an additional \$400,000 each subsequent year. The source of funds for the LOC was an Arts Stabilization Loan Fund (General Fund) created in 2006. As of September 20, 2011, the Rep has drawn \$1,993,443 on its LOC, leaving a balance of \$6,557. Under the current LOC terms, the Rep is required to repay approximately \$400,000 on October 31, 2011.

The current LOC further stipulates that the Rep will make monthly interest payments to the City on the unpaid principal amount of the revolving loan. The interest is currently paid at a rate of 0.727%, which varies based on City's investment portfolio yield. To date, the Rep has paid \$203,715 in cumulative interest on the LOC. The LOC Agreement further stipulates that any operating cash-on-hand over \$50,000 at any time is required to be applied to the outstanding LOC principal.

In FY 2011-2012, the Rep was also awarded an Office of Cultural Affairs grant of \$100,482 (Transient Occupancy Tax) to support its programming. Like other cultural institutions that operate City facilities, as part of the 2011-2012 Adopted Budget, the Rep receives a \$285,000 General Fund annual subsidy to operate and maintain the Hammer Theatre. The amount of this subsidy was reduced by 5% (\$15,000) from the 2010-2011 Adopted Budget. The 15-year Operations and Maintenance (O&M) Agreement expires in 2017, and the Rep has the option to extend the agreement for two additional terms of 10 years each through 2037.

Need for Restructuring the LOC and Revised Terms

Despite improvements to the Rep's financial position, it has not generated the necessary surplus to meet the terms of its current LOC Agreement and pay down the approximately \$400,000 in principal on the LOC October 31, 2011. The inability to make the payment is due to the organization's slower-than-expected financial recovery amidst the U.S. recession. In the event of a default, the City has the right to declare all sums immediately due and payable and suspend or terminate any disbursements of the revolving loan. Should the City declare all sums immediately due, given that the Rep does not have the funds to repay the \$2,000,000, the City would likely be unable to collect the funds.

Although the Rep has made significant progress since the LOC was established in 2006, the Rep's FY 2009-2010 audited financial statements contain a "going concern" note, reflecting the organization's still vulnerable financial situation. The Rep's long-term debt in 2010 was approximately \$4,800,000. In FY 2009-2010, the Rep had an operating loss of \$773,019, which included noncash depreciation expenses valued at \$306,602.

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However, the Rep leadership anticipates that its audited financial statements for FY 2010-2011, which ended on August 31, 2011, will reflect an operating surplus for the first time since FY 2006-2007. The audit is expected to be complete by November 2011. The improvement in the financial position of the Rep is a result of increased revenue through fundraising and ticket sales as well as tight cost controls. The Rep's improvement is also the result of concentrated efforts over the past several years to reassess and improve all aspects of the organization. These efforts have resulted in positive changes to the Rep's organizational culture and governance structure including increased transparency, open communication internally and externally, and a variety of tools and reports that allow the Rep's Board and management to monitor financial performance and make adjustments as necessary. Annual subscription renewals continue to be above the national average for regional theaters, while opportunities for improvement still exist in the areas of single ticket sales and fund development. Overall, the organization has shown the ability over the last five years to make improvements in areas that will position the Rep for future financial stability.

Regular Monitoring and Capacity Building Efforts

Over the past two years, the City has increased its monitoring and involvement in the Rep's finances including regular monthly monitoring. The City also continues to support the Rep's financial recovery and revenue generation through a variety of strategies. These include support of the Rep's participation in the New Pathways for the Arts cohort, which includes intensive facilitation to foster innovation in arts management practices and a modest risk capital grant, support of its applications to foundations, and brokering partnerships for social media marketing promotions through the Shop San José campaign.

Concurrent with its efforts to support the Rep in its recovery efforts, the City has developed a contingency plan for the operation of the Hammer Theatre to ensure that it remains a viable community asset, if the Rep were to become unable to maintain its presence in the theater.

ANALYSIS

Considerations Informing the LOC Restructuring

In light of the Rep's inability to meet the repayment terms of the current LOC Agreement, it is recommended that the revolving loan LOC agreement be converted into a Term Loan Agreement with revised payment terms.

With more realistic payment terms, the City retains a higher probability of receiving repayment on the \$2,000,000 loan. If the Rep ceases operations, the City will lose \$2,000,000. In this scenario, while the \$285,000 O&M subsidy would no longer be paid, the City would take on other immediate costs. The Department of Public Works estimates the cost associated with the basic maintenance of a shuttered theater will be \$105,000 per year. If the City operates the theater, the annual cost is estimated at \$685,000 until an alternative operator can be found.

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Based on recent facility reuse efforts at the Mexican Heritage Plaza, staff costs of facility re-use planning could be extensive.

Converting the revolving loan LOC into a Term Loan, with terms that include a gradual repayment over time, facilitates the financial recovery and sustainability of the Rep, an important anchor in the economic and cultural vitality of the downtown. The LOC will no longer function as a revolving loan to facilitate the Rep's cash flow in which the Rep can pay down on the amount drawn and subsequently reborrow. Instead, it will function as a term loan with the Rep paying down principal on an annual basis and making interest payments on a monthly basis.

The 2011-2012 Adopted Budget does not assume repayment of any loan amount from the Rep. Reduced annual repayment levels will not increase the General Fund shortfall.

Recommended Revised Terms

Utilizing conservative base case projections, it is recommended that the payment terms be revised to reflect gradual annual paydown over 25 years. Highlights of the terms in the new agreement will include:

- A. Remaining five years on LOC would be restructured into a 25 year loan, with base annual repayment levels of \$35,000-\$81,818 to begin in April 2012.
- B. Annual principal payments were developed using a conservative base case projection of the Rep's financial capacity. Therefore, the payments gradually increase over five years and then remain constant. The first principal payment due in 2012 will be \$35,000. The payment increases to \$50,000 in 2013 and 2014. In 2015, the payment increases to \$65,000. In 2016, it increases to \$81,818 and remains at this rate through 2037.
- C. The loan end date will align with the O&M agreement, which will expire in 2037, if the Rep exercises the option to extend the agreement in 2017 and 2027 for a 10 year period each.
- D. The Rep will pay simple interest monthly at a variable rate based on City's investment portfolio yield as determined on an annual basis.
- E. Principal repayment due dates will be aligned to the spring period when the Rep's cash position is stronger.
- F. The Rep will be required to develop a minimum operating reserve. By August 31, 2013, it will be required to have a minimum of \$100,000 in reserve and, by August 31, 2018, the equivalent of one month's worth of annualized operating expenses in reserve. Progress on this condition will be monitored to ensure the Rep is consistently building reserves. Should this minimum not be met, the City will require a corrective action plan and have the right to reconsider the terms of this loan.

The benefits of these revised terms include:

- City's General Fund will be repaid on a consistent and predictable annual schedule beginning in FY 2011-2012;

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- City is estimated to receive additional cumulative interest of \$920,000 over the 25 years of the agreement;
- Conversion to a term loan will result in the Rep no longer being dependent on the City to manage its cash flow needs;
- Conversion to a term loan will reduce the City administrative burden of managing the LOC;
- The Rep is supported on a path to financial stability and has increased capacity to eliminate its debt, which aids its fundraising efforts; and
- The allowance of the downtown to continue to thrive as a regional arts and cultural center with the Rep's on-going presence in the Hammer Theatre Center, which was originally conceived and developed for the Rep's use.

EVALUATION AND FOLLOW-UP

The financial position of the Rep will continue to be monitored monthly by Finance and Economic Development staff.

POLICY ALTERNATIVES

Alternative #1: Do not approve a new loan agreement with new terms.

Pros:

Not approving a new loan agreement would result in the Rep being required to repay \$2,000,000 in five years, including approximately \$400,000 by October 31, 2011.

Cons:

Should the Council choose to not approve a new loan agreement with new terms, this would most likely result in the Rep's default on the LOC agreement.

Reason for not recommending:

The Rep does not have the funds to meet the current terms of its LOC agreement.

PUBLIC OUTREACH/INTEREST

This topic was discussed at the regular meeting of the Arts Commission on September 14, 2011.

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

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- 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)**

COORDINATION

This item has been coordinated with the City Attorney's Office and the City Manager's Budget Office.

FISCAL/POLICY ALIGNMENT

This recommendation aligns with the vision of the City's *Economic Strategy 2010* that San José is 1) a creative community that pioneers innovation within and across technology and business, culture and society and 2) the world's most livable big city with diverse and distinctive qualities of life.

A robust cultural life is a key indicator of quality of life. As cities become increasingly competitive in attracting business and a talented workforce of all ages, quality of life becomes increasingly important. Ensuring that San José has a distinctive set of arts, entertainment and sports offerings aligned with San José's diverse, growing population is Economic Strategy Goal #12.

This recommendation also aligns with *Cultural Connection: San Jose's Cultural Plan for 2011-2020* and its goals to 1) support the availability of diverse cultural spaces and places throughout the community and 2) strengthen downtown San José as the creative and cultural center of the Silicon Valley.

COST SUMMARY/IMPLICATIONS

The Rep does not have the ability to meet the terms of the current LOC agreement when the LOC drops to \$1,600,000 on October 31, 2011, and it is required to repay the amount drawn above \$1,600,000. In the event of a default, should the City declare all funds immediately due, the Rep cannot repay the full \$2,000,000. If a modification to the LOC is approved, the cost implications to the General Fund will be an extended term for the repayment by an additional 20 years. The City will collect interest on the outstanding loan balance at a variable interest rate

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consistent with the City's investment portfolio, estimated at \$920,000 for the remaining term of the recommended term loan.

BUDGET REFERENCE

Not applicable.

CEQA

Not a Project, File No. PP10-066(e) Services that involve no physical changes to the environment.

/S/
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/S/
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For questions please contact Kerry Adams Hapner, Director of Cultural Affairs at (408) 793-4333.