Overture Center Refinancing
October 10, 2005
Re: Legistar Resolution #02074

Fiscal Note

This resolution authorizes the City to enter into loan agreements and modify the current Operation and Cooperation Agreement with the Madison Cultural Arts District (MCAD) to assist in refinancing debt related to the Overture Center. The purpose of the proposed financing plan is to preserve the possibility of a long-term revenue stream, generated by the investment of the W. Jerome Frautschi gift, to be used for the benefit of Overture Center operations. As part of this refinancing, the City would provide a credit backstop, pledging to pay the annual debt service on a $27,700,000 loan in the event that investment earnings and other pledged resources are insufficient to make the required debt payments during the next 6 years.

Current Structure

Under the current financing plan adopted in 2001, the Frautschi gift for the Overture Center was invested to help support future operation of the facility. Overture Development Corporation (ODC), the entity responsible for construction of the facility, borrowed $115,000,000 through a bond issued by the Madison Community Development Authority (CDA). The proceeds of that borrowing have been used toward the construction of the facility.

Repayment of the borrowing is secured with a letter of credit issued by a consortium of local banks that is, in turn, backed by the original Frautschi gift and additional temporarily pledged assets. Taken together, the current market value of Mr. Frautschi's original gift, along with the additional assets he has pledged, totals approximately $141,000,000. The original gift assets remain invested by the Madison Cultural Arts Support Trust (MCAST).

Reason to Refinance

As Phase II of the Overture Center project continues, approximately $34,000,000 of the additional assets pledged by Mr. Frautschi will be used to complete construction. That will leave his original gift, currently valued at approximately $107,000,000, to provide credit support for the $115,000,000 of outstanding bonds. Because the terms of the bank letters of credit require a substantially greater investment value than the amount of the outstanding debt, the value of the remaining assets will be insufficient to support the current letter of credit amount. At that point, the existing financing structure will no longer be viable. If a new structure is not put in place by the end of October 2005, ODC and MCAST representatives have stated that all remaining investments will be sold to pay off the outstanding debt. Overture Center construction would be fully completed by ODC as scheduled by early 2006.

Under this scenario, the potential for a continuing revenue stream to support future Overture Center operations generated by the investment of the remaining Frautschi gift would be lost. The proposed refinancing plan is an attempt to preserve that possibility.

Proposed Refinancing

The proposed refinancing plan would divide the existing debt into two separate pieces. Of the $115,000,000 in bonds outstanding today ("Series A"), $27,700,000 would be paid off and replaced with a new loan of the same amount ("Series B"). The underlying conditions of the remaining $87,300,000 "Series A" bonds would stay in place, including the variable interest rate, the original 35-year term and existing letter of credit structure. MCAST would continue to invest the original Frautschi gift, presently valued at approximately $107,000,000. If maintained at this market value, the asset would be sufficient to provide collateral support for the remaining $87,300,000 of the original bond issue, but not for the newly issued "Series B."

MCAD and the banks involved in the proposed refinancing have asked that the City step in to provide the credit support needed for the new "Series B" loan, replacing the additional assets temporarily pledged by Mr. Frautschi but now used to complete construction. The City would pledge to make an annual debt service payment of up to $2,500,000 if debt cannot be paid from the earnings of the MCAST investment or other defined sources. This new "Series B" debt would be in the form of a bank loan to ODC, underwritten by a consortium of 2 local banks. JPMorgan Chase Bank (formerly Bank One) and US Bank have partnered to co-lead this transaction (as well as the letter of credit for the "Series A" bond). The loan would be for a term of 6 years, with principal repayment amortized over a period of 25 years and a fixed interest rate estimated to be up to 8%. Under the terms of the loan, the bank group would make available an additional line of credit of up to $2,500,000 to ensure that sufficient funding can be drawn upon to make scheduled debt payments in a timely manner.

The City's commitment would be to pay off this line of credit in the event that it is ever drawn upon. The loan terms provide for a "cure period" that would allow the City sufficient time to budget for any required payment in the course of the normal annual budget process. This provision would also help the City manage its expenditure responsibly within the limits of the State Expenditure Restraint Program, the newly enacted municipal levy limit legislation, or other similar budgetary limitations that may arise in the future.

Presently, the City holds a property interest in the Overture Center that allows the City to take ownership of the facility for $1.00 if it ceases to be operated as a public performing arts center. As an additional form of security for both the "Series A" and "Series B" loans, the banks will take a $40,000,000 first mortgage on the Overture Center property and require that the City subordinate its reversionary interest, so that in the event of a default, the banks would have first claim to the property.

The City's promise to pay off the debt service line of credit would not be a general obligation debt. Rather, it would be a contingent liability that, while noted in the City's audited financial statements, would not impact the City's legal debt limit or capacity to issue general obligation debt in the future.

"Firewalls"

The proposed Overture refinancing has been structured to limit the likelihood that the City would be called upon to make debt payments. A number of other potential resources could be drawn upon first, if MCAST investments are insufficient to cover all planned debt payments. These protective layers or "firewalls" include (see separate graphic):

- MCAST could, at its discretion, direct any available resources to make debt payments before providing any annual operating grants to MCAD.

- Mr. Frautschi has committed to providing a "backstop" during the first 4 years of the "Series B" loan term, promising to pay debt service costs of up to $2,500,000 in any given year during that period, up to a total of $5,000,000.

- MCAD would be required to set aside all but the first $250,000 of any operating grants received from MCAST until a funded reserve of $2,500,000 has been accumulated. This reserve would remain in place and available for payment of Series 'B' debt if future MCAST earnings are insufficient to do so.

- The Madison Community Foundation could be asked to permit distribution of portions of the existing Civic Center Endowment Fund if needed for debt service. Currently, approximately $1,400,000 would be available for this purpose, at the discretion of MCF.

- The $2,500,000 debt service line of credit made available by the bank under the terms of the "Series B" loan agreement would be drawn upon, allowing the City to delay any required payment until it can appropriate the necessary funds in its next annual budget cycle.

As a result of this refinancing, the City would assume a maximum risk of making an annual debt service payment on the $27,700,000 "Series B" bank loan of up to $2,500,000 per year for the 6-year term of the loan. This obligation would only arise, however, if the earnings from the MCAST investment are insufficient to make these payments and the other identified funding sources, or "firewalls," have been exhausted. The availability of Mr. Frautschi's $5,000,000 "backstop" pledge during the first years of the refinancing, along with any accumulated operating reserves of the Overture Center make it unlikely that the City would be required to make any debt payments during at least the first 3 years of the 6-year loan period.

The City's pledge would be a "moral obligation" and subject to appropriation. Thus, a future Common Council could avoid payment by failing to budget the necessary funds. Such an action, however, would be viewed by the bond market as a default similar to a default on a general obligation debt. Not only would the City lose its exceptional bond rating, it would lose the ability to borrow altogether.

Under the financial structure that is in place today, the City has no responsibility for the repayment of debt related to Overture Center construction. Overture Development Corporation, the developer of the facility, is solely obligated to pay debt service and the existing bonds do not constitute an indebtedness of the City or the CDA. This would continue to be true for the $87,300,000 of existing debt that would remain in place as "Series A" after refinancing.

Revisions to Operating Agreement

As a condition of the refinancing, certain provisions of the existing Operation and Cooperation Agreement between the City and MCAD would be modified as defined in the resolution. These changes could be structured to ensure that all available MCAD resources would be committed to repay the City for any required debt service line of credit replenishment it has made.

Financial Risks

As with the original Overture financing, the future success of the proposed refinancing structure will be highly dependent on the rate of return generated by MCAST as it manages the investment of the Frautschi gift. That asset will be invested in a mix of stocks, bonds and other investment vehicles selected to achieve a high enough return to pay all fees, debt service for both "Series A" and "Series B", and an annual operating contribution to MCAD. Investment decisions will be made by MCAST, and MCAST will determine the amounts and purposes of any annual distributions from the trust, subject to terms specified in the bond and loan agreements. To date, MCAST has made no operating grants to MCAD. Under the proposed structure, the City would have no contractual relationship with MCAST that would allow it to influence when distributions would be made from the trust or to determine the purposes for which distributions are made.

Today, the fair market value of the assets that will be invested to support this structure is approximately $107,000,000. Under the terms of the refinancing as negotiated with the bank group:

- If the fair market value of this portfolio remains at more than $104,000,000, then MCAST will be allowed (although not required) to make distributions to cover debt service on "Series A" bonds, the "Series B" loan and, in addition, operating grants to MCAD of up to $1,400,000 per year.

- If the fair market value falls to between $100,000,000 and $104,000,000, MCAST will be allowed to make distributions to cover debt service on both "Series A" bonds and the "Series B" loan, as well as smaller annual payments to support Overture Center operations.

- If the fair market value of the investment falls below $100,000,000 but not below $97,000,000, funds from the account may only be released to make debt payments on "Series A". If this condition occurs, the bank group would next look to the identified "firewalls" and then to the City to pay "Series B" debt service.

- A reduction in the fair market value to less than $97,000,000 would be deemed to be a default under the "Series A" bond, requiring that all investments be converted to short-term US Government securities until such time that alternative arrangements can be made. In this situation as well, the bank group would look to the identified "firewalls" and then to the City to pay "Series B" debt service.

It is difficult to predict the likelihood that the City would be called upon to make a payment under the proposed structure because the financing structure is highly sensitive to investment performance in the near term. Based on the most recent financial modeling, the City could be called upon to make payments, particularly in the last one to two years of the proposed 6-year "Series B" loan term, if the cumulative rate of return achieved by MCAST falls below long term historical market averages. To illustrate:

- A cumulative annual return that does not fall below 8% would be sufficient to pay all estimated debt service, costs and a $1,400,000 annual operating contribution to MCAD. None of the "firewalls" or the City would be called upon to make debt payments.

- A cumulative annual return of 6% would be sufficient to cover required fees, debt service and a $1,400,000 operating payment to MCAD for the first two years. In the third year, the MCAD operating subsidy would be reduced and no subsidies would be available in subsequent years. Mr. Frautschi would likely be called upon to cover debt service in the fourth year, MCAD reserves in the fifth year, and the City in the sixth.

- If investment returns remain positive but fall below a cumulative average of 4%, the long-term viability of this financing arrangement would be jeopardized, and the City could be called upon to make debt payments after any accumulated "firewall" protections have been exhausted. The proposed $5,000,000 pledge from Mr. Frautschi is structured in such a way to ensure that debt payments would be covered for up to 2 of the first 4 years, with MCAD and the City covering the remaining period.

The other circumstance in which the City could be called upon to make debt service payments, however, would occur if MCAST experienced a significant net loss during the first few years, due to the normal short term volatility of its investment portfolio. Based on the current value of $107,000,000, a cumulative drop of more than 9%, to $97,000,000, would constitute a serious challenge to the proposed financing structure. At that point it would be determined by the participating lending institutions that the value of the investment portfolio had fallen below the level required to "collateralize" the "Series

A" bonds. The underlying letter of credit financing structure would then begin to unwind. If the "Series A" bonds were paid off as a result, the City would be called upon to make any remaining "Series B" debt payments during the remaining term of the 6-year loan, and after any remaining "firewalls" had been exhausted.

It should be noted that, since June 30, 2001, the MCAST investment portfolio has generated a net annual investment return of approximately 3.17%, with annual results ranging from a positive return of 24.08% to a loss of 20.41%.

Conclusion

The proposed refinancing structure has been designed to minimize the City's financial risk while providing needed credit support to maintain the long-term investment potential of the Frautschi gift. The City's risk is limited to an annual debt service payment of up to $2,500,000 during the 6-year loan term. City payments would only be required if a series of other potential resources were first depleted, and the "cure period" built into the structure would allow the City to plan for any required expenditure as part of the normal budget process. Given the proposed "firewalls," including the $5,000,000 "backstop" pledged by Mr. Frautschi, it is unlikely that the City's exposure would exceed a 3-year period (during the years 2009, 2010 and 2011).

There is little margin, however, between the current $107,000,000 value of the MCAST investment portfolio and the minimum needed to support the proposed financing structure over the long term. While the $87,300,000 "Series A" bond is structured to remain in place for an additional 30 years, the City's contingent liability would only remain in place for the 6-year life of the $27,700,000 "Series B" loan. With no planned principal payments during this period, the unpaid balance of the "Series A" bonds would remain at $87,300,000, and the "Series B" loan will have a remaining balance of $25,000,000. The proposed refinancing does not address how the "Series B" loan would be collateralized at the end of this 6-year period. It is likely that the parties to this transaction would again face a similar set of difficult decisions about the refinancing of Overture Development Corporation debt at that time.

Respectfully Submitted,

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City Comptroller