MINUTES OF THE AUGUST 26, 2013, FINANCE COMMITTEE MEETING

The Finance Committee ("the Committee") of the Board of Regents of the Smithsonian Institution held a meeting on August 26, 2013, at the Smithsonian Castle in Washington, D.C. Participating were Committee Chair David Rubenstein* and Committee members France A. Córdova*, Representative Xavier Becerra*, and Roger W. Sant*. Senator Thad Cochran and David Silfen were unable to participate.

Participating staff included Secretary G. Wayne Clough; Chief of Staff to the Secretary Patricia Bartlett; Chief Investment Officer Amy Chen*; Inspector General Scott Dahl; Smithsonian Enterprises (SE) Chief Financial Officer Bruce Dauer; Office of the Regents Senior Writer-Editor Barbara Feininger (recorder); Under Secretary for Finance and Administration and Chief Financial Officer Albert Horvath; Office of Planning, Management and Budget Associate Director Ken Johnson; Deputy Under Secretary for Finance and Administration John K. Lapiana*; Associate Director for Finance Albert Lee; General Counsel Judith Leonard; SE President Chris Liedel; Assistant to Congressman Becerra Grisella Martinez*; Deputy General Counsel Marsha Shaines; and Office of Planning, Management and Budget Director David Voyles.

CALL TO ORDER

The Chair called the meeting to order at 2:01 p.m. He noted the series of motions presented for the Committee's consideration. [The notes of the April 24, 2013, Committee meeting were included in the meeting materials but, as a quorum had not been present at that meeting, the notes were not presented for approval.]

PROPOSED DEBT ISSUANCE

The Committee was asked to consider a proposal to recommend that the full Board authorize the issuance of up to $100 million of new external debt, in bonds, to provide bridge financing for major Trust-funded capital initiatives, including the construction of the National Museum of African American History and Culture (NMAAHC). Mr. Rubenstein asked Under Secretary for Finance and Administration and Chief Financial Officer Al Horvath to discuss the proposal.

Mr. Horvath noted that the Smithsonian is in the midst of a significant period of capital activity, much of which is dependent upon Trust funding. Management, he said, has determined that medium-term bridge financing would provide the steady cash flow needed to address Trust-funded capital needs. Because the Smithsonian's ability to carry indefinitely bridge financing needs would be strained by the combination of capital projects, staff discussed several financing variables with the Finance Committee at its April 24, 2013, meeting. The Committee requested that a specific proposal be presented to the Committee at this meeting.

Staff and investment advisor JP Morgan evaluated a wide range of options, he said. Because of market conditions over the past few years, it was determined that up to $100 million in financing should be completed in two taxable tranches for a period of no longer than 10 years. Separate issuance of five- and 10-year bonds with a combination of fixed- and variable-rate structures would be pursued.

This approach, said Mr. Horvath, will be more expensive because the spread between taxable and tax-exempt rates has increased over the past few months. These costs, however, will be offset by issuance and timing issues. Proceeds will allow the NMAAHC project, including its construction and exhibition development, to move forward towards the museum's planned opening in November 2015. Funding from the Central Trust budget will finance the debt's annual interest expenses while donor pledge payments will finance the debt's principal expenses. Mr. Horvath reviewed the proposed implementation calendar and noted that the timing of the issuance could be as soon as late October 2013.

Informal discussions with rating agencies, said Mr. Horvath, indicate that the proposed short-term debt offering probably will not adversely impact the Smithsonian's AAA rating. The proposed debt issue will be presented to the Board for its approval at a special phone meeting on September 5, 2013, after which formal meetings with rating agencies will be scheduled.

Dr. Córdova asked if the Smithsonian is confident that the remaining private funds for NMAAHC can be raised and when those funds must be received. Mr. Horvath noted the strong private fundraising performance of the NMAAHC over the prior six months and the strong pipeline of potential gifts. The plan, he said, anticipates that all pledged funding will be in hand within 10 years. He also said that the five-year term of the variable-rate bond is intended to help reduce annual risk exposure.

Dr. Córdova asked if forecast NMAAHC operations, as noted in the meeting materials, will be sufficient to meet the full interest expense during the lifetime of the debt. Mr. Horvath explained that operations are in fact projected to be higher but emphasized that the most important issue will be the continued fundraising efforts of the museum. Mr. Sant asked if the 10-year fixed-rate taxable bond will be pre-payable. Mr. Horvath explained that, although a final decision has not been made regarding that option, the additional cost of a call may negate any financial gain made from exercising a prepayment.

Representative Becerra asked how the Smithsonian plans to approach donors to ensure buy-in following the debt issuance. Mr. Horvath said that relations are strong with already committed donors and that prospective donors will receive the strong message that their support will enable the museum to meet its November 2015 opening.

The Secretary noted that it is anticipated that about $140 million of the museum's $250 million private fundraising goal will be committed by the end of fiscal year 2013. Vigorous fundraising efforts, however, will continue. Representative Becerra expressed his support for the bridge loan but suggested that NMAAHC Director Lonnie Bunch personally assure the Board that strong fundraising efforts will continue apace. He also noted that the Board must understand that this is a short-term loan. Mr. Rubenstein suggested that Mr. Bunch, NMAAHC Council

Chair Ken Chenault, and/or Director of Advancement and Philanthropic Giving Virginia Clark participate in the Regents' conference call scheduled for September 5.

Mr. Rubenstein expressed his support for the proposed action, given that additional funding from the Congress is unlikely. He said the timing of the debt issuance is good because interest rates are likely to go up, and postponing the decision would likely result in higher interest rates. He noted that NMAAHC fundraising has increased but acknowledged it will be a challenge to secure the remaining funds by the date of the museum's planned opening.

Mr. Rubenstein noted that the final split between fixed and variable rates will likely be determined at the time of the debt issuance. The Committee then considered a proposed motion to recommend approval by the Board of external debt issuance. The following motion was approved:

> **VOTED** that the Finance Committee recommends that the Board of Regents approve the issuance of up to $100 million of new bonds to provide financing for various Trust-funded capital projects. This new taxable debt, to be issued prior to the end of calendar year 2013, will mature at five years and 10 years from date of issue and is expected to be a mix of fixed-rate (up to $50 million) and variable-rate (up to $50 million) bonds. Interest rates on the final issuance should be less than 4 percent annually (fixed rate, 10 years) and 1 percent annually (variable rate, five years). The Secretary and his designees are authorized to determine the final specific form of this bond issue in consultation with the Institution's investment advisors and bond counsel, and subject to market conditions at the time of issuance within the parameters noted above.

PROPOSAL TO USE EQUITY INVESTMENTS BY SMITHSONIAN ENTERPRISES

The Committee considered a request from Smithsonian Enterprises (SE) for authority to pursue equity investments with third parties. The proposal, said Mr. Rubenstein, is designed to advance the Smithsonian's mission and accelerate SE's ability to increase revenues. He explained that SE would invest $15 million–$20 million in about six to eight ventures that align with other SE activities. The activities would occur over the course of three to four years. Authorization by the Committee would be on behalf of the full Board, as also would be the approval of SE's first investment. He asked SE President Chris Liedel to present the proposal.

Mr. Liedel said the investments will help the Smithsonian advance its financial and programmatic imperatives. SE is considering businesses invested in education, digital space, online, and mobile opportunities, all of which will help the Smithsonian reach more global and younger audiences. Modest growth rates, noted Mr. Liedel, are projected for most of SE's existing businesses. These strategic investments will help accelerate the SE's entrance into new market areas by bringing in the expertise of outside partners. He cited the Smithsonian Channel as a successful example of a similar investment model.

Using feedback from Finance and Executive committee members, among others, a framework for an equity fund was developed that is based on a 10-year timeline. Investment guidelines would be similar to those used by the Investment Committee with the exception that partners would be allowed to use the Smithsonian brand and projects would be co-developed.

Mr. Sant asked Mr. Liedel to further explain how such investments would provide greater access to technologies that the Smithsonian couldn't otherwise get. Mr. Liedel explained that E-Line Media, the initial investment under consideration, is an educational gaming company focused on STEM- and history-based games. The partners would co-develop products, as well as brand existing products, all of which would be carefully vetted to ensure they uphold the reputational standards and practices of the Smithsonian. The initiative, said Mr. Liedel, will offer shorter development times, a wider platform of products, access to other partners, knowledge transfer to Smithsonian staff, exposure to new technologies, and international expansion. The Smithsonian's brand recognition will accelerate the growth of the business.

The Secretary noted that about two Smithsonian staff members currently are involved in digital gaming, and that a few popular products have been produced with university partners. Like the Smithsonian, however, the universities are dealing with funding challenges and the development of the products has been laborious. The proposed initiative, he said, will allow the Smithsonian to have a larger, faster impact, as well as present opportunities for greater financial returns that could fund additional activities.

Dr. Córdova commented on the size of the investment and the risks involved in the venture. Mr. Horvath said that because SE's traditional businesses do not promise significant growth, other ways to expand revenue are being explored. He compared the proposed activity to the Investment Committee's decision to invest in alternative investments. Mr. Horvath said that SE must employ a number of mechanisms, including the use of equity investments on a limited basis, if it is to offer the highest upside in Trust revenues.

Mr. Liedel noted that the single-biggest growing asset SE currently has is its investment in the Smithsonian Channel. He said SE is employing a balanced revenue growth model by considering what can be developed internally, what can be accomplished through conventional brand licensing, and where are investment opportunities that will utilize the Smithsonian's expertise and allow the brand to resonate. The education market was cited as one such opportunity.

Mr. Horvath emphasized that substantial due diligence and infrastructure will be applied to the development and monitoring of the investments. SE, added Mr. Liedel, has been asked to generate a 12 percent annual return on the Smithsonian's investment in these activities.

Mr. Sant said the initiative could help the entire Smithsonian advance in, and have greater access to, digital media and online commerce opportunities. Representative Becerra asked for examples of similar investments by peer institutions. Secretary Clough noted that the American Museum of Natural History and the Museum of Modern Art are two cultural institutions that are investing heavily in the field of online courses. Mr. Liedel said that the MacArthur

Foundation and PBS are just two of several nonprofit organizations that are already involved with E-Line Media. He also assured Representative Becerra that the size and range of SE's proposed investments are comparable to those made by similar institutions. He said SE would invest in institutions with revenues, not just concepts, and with groups that have proven track records in growth.

Representative Becerra asked if there were any potential conflicts of interest with E-Line Media. Mr. Liedel responded that a legal review is not completely finished. SE, he said, has been assured that Dr. Córdova's nomination as the next National Science Foundation (NSF) director is not in conflict with NSF funding that already has been granted to the E-Line collaboration. No other conflicts have been identified.

Representative Becerra asked how the Smithsonian will provide effective and transparent management of the initiative. Mr. Horvath said the Finance Committee will receive regular reports on the initiative and annual reports will be provided to the full Board. Due diligence requirements, he said, are still under development, and additional staff or consultants may be required. Mr. Liedel said there are budgeted SE positions that will be able to provide necessary expertise, management, and feedback to the Regents as the initiative ramps up.

Mr. Rubenstein expressed his opinion that he supports the initiative, and that he believes that any risks it might present are reasonable. He asked if there were any further comments about the two proposed motions.

Dr. Córdova suggested that the proposed resolution to authorize the pursuit of equity investments should clearly state the oversight mechanisms for the initiative. Mr. Horvath noted that, before a commitment is made, each investment would be individually brought to the Finance Committee for review. He also said that a protocol could be developed that will guide the effective and transparent oversight of, and communications about, the investments. The Board, said Mr. Rubenstein, should be regularly updated about each investment's performance.

Subsequent to the modification of the first proposed resolution, the following two motions were later approved:

> **VOTED** that the Finance Committee approves the Smithsonian, through Smithsonian Enterprises, strategically taking ownership positions, in a manner consistent with applicable law, in high-growth, mission-compatible enterprises that will contribute to the increase and diffusion of knowledge. It is anticipated that such relationships could ultimately number six to eight and represent an investment of $15 million to $20 million. Funding for such investments will come from non-endowed reserves of the Institution. Each proposed individual investment will be brought to the Finance Committee for approval, and Smithsonian Enterprises will update the Finance Committee and Board of Regents regularly on the progress of each investment.

> **VOTED** that the Finance Committee approves an investment of $1.7 million for a 10 percent equity stake in E-Line Ventures, LLC.

FISCAL YEAR 2014 FEDERAL AND TRUST BUDGETS

The Finance Committee was asked to recommend that the Executive Committee, on behalf of the Board, approve the budget of appropriated funds for FY 2014 and authorize expenditures by the Secretary. Mr. Rubenstein asked Mr. Horvath to discuss the FY 2014 Federal and Trust budgets.

Mr. Horvath said that Federal budget guidance for FY 2014 and FY 2015 remains very unclear. FY 2013 Federal appropriations total just under $775 million and a continuing resolution is anticipated for part or all of FY 2014, which would hold funding at FY 2013 levels. Funding could in fact could be further reduced. With regard to the Trust budget, the FY 2014 fundraising goal will be modestly increased. Fundraising for the national campaign, noted Mr. Horvath, is ahead of schedule. The FY 2013 stretch goal for government grants and contracts will be maintained for FY 2014, although the full impact of sequestration on granting agencies remains uncertain. A modest bottom-line increase is anticipated for SE, and funding from the Endowment payout will remain essentially flat.

The Committee then approved the following motion:

> **VOTED** that the Finance Committee recommends that the Board of Regents approves the budget of appropriated funds for fiscal year 2014 when signed into law by the President and the institutional budget for Trust funds for fiscal year 2014 reflected in this report, and authorizes expenditures by the Secretary in accordance therewith. Any material changes in program plans incorporated into this budget shall be made only with the approval of the Board of Regents or its Executive Committee.

FISCAL YEAR 2015 FEDERAL BUDGET REQUEST TO THE OFFICE OF MANAGEMENT AND BUDGET

At the time of this meeting, Congress had not passed the FY 2014 Federal budget. Nevertheless, the Smithsonian is required to submit a FY 2015 budget request to the Office of Management and Budget (OMB) on September 9, 2013. To meet that deadline, the Committee was asked to recommend that the Executive Committee, on behalf of the Board, approve the budget request at its August 28, 2013, meeting. The motion also would be brought to the full Board at its September 5 conference call.

Mr. Horvath was asked to summarize the status of the FY 2015 Federal budget negotiations. Mr. Horvath directed the Committee's attention to a chart in the meeting materials that included OMB's FY 2015 guidance number ($839 million), as well as 5 percent and 10 percent reductions ($847 million and $803 million, respectively). Mr. Rubenstein noted that the appropriations approved by Congress will likely be lower than those recommended by OMB.

In response to a question from Mr. Sant, Mr. Horvath explained that a full FY 2014 sequestration, if added to a FY 2014 continuing resolution, would result in an additional reduction of 2.5 percent to FY 2013 Federal funding levels. Mr. Rubenstein asked the Secretary if the Smithsonian is making contingency plans to prepare for reduced funding in FY 2015. Secretary Clough assured the Committee that management has developed detailed plans to deal with the possible budget scenarios that are known at this time. One cost-savings example he cited was the possible reduction in the days that low-attendance museums are open to the public.

The Committee then approved the following motion:

> **VOTED** that the Finance Committee recommends that the Executive Committee approves, on behalf of the Board of Regents, the Smithsonian Institution's budget request for appropriated funds for fiscal year 2015 for presentation to the Office of Management and Budget. Any material changes in program plans incorporated into this budget shall be made only with the approval of the Board of regents or its Executive Committee.

ADJOURNMENT

There being no further business, Mr. Rubenstein thanked the participants for their contributions. The meeting was adjourned at 3:04 p.m.

Respectfully submitted,

David Rubenstein
Committee Chair