

RESOLUTION FOR THE AUTHORITY TO FORGIVE AND DISCHARGE LOANS TO THE VIRGINIA TECH - APPLIED RESEARCH CORPORATION

FINANCE AND AUDIT COMMITTEE

September 26, 2016

The Committee received an update on the operations of the Virginia Tech-Applied Research Corporation (VT-ARC) during its August 2016 meeting. The Committee asked for periodic updates in the future as needed for the Committee to understand the evolving status of VT-ARC. This report provides additional information on VT-ARC's status. The report also includes a resolution for the proposed discharge of a loan from the university to VT-ARC.

Background

VT-ARC was created as a separately incorporated affiliated organization to pursue externally funded applied research opportunities that are not reasonable to be conducted within the university because of factors such as cost accounting requirements, business risk, and joint ventures. The focus of the efforts of VT-ARC has been in the National Capital Region, although some personnel and activities occur in Blacksburg.

Operations and Activities

VT-ARC began operations in 2011. The funding for the initial phase of the operations and the investment in equipment and specialized facilities improvements needed for the research programs was provided by the Virginia Tech Foundation (VTF).

As described to the Committee during its August 2016 meeting, VT-ARC has experienced mixed operating results since its initial operating activities. Several factors contributed to this situation, including: a) the federal budget and sequestration actions which dampened and delayed the ability to obtain federally funded contracts, b) the expenses necessary to attract and hire highly qualified, professional staff who have the talent to identify and secure contracts from government and industry, c) the identified need for secure space in the National Capital Region, and d) limited engagement of research faculty at Virginia Tech with VT-ARC.

Status of Financing Activities

Consistent with the initial business forecasts for VT-ARC, it was anticipated that the initial funding from the VTF would be sufficient as start-up funding and that the corporation would quickly gear up its business activities, resulting in incremental revenues at levels needed to generate revenues to become self-sufficient. However, VT-ARC's success in obtaining externally funded contracts was slower than originally anticipated, and over time additional

investments for working capital have been needed. With the business development efforts both slower and at lower amounts than anticipated, the VTF also agreed to provide supplemental operational funding to provide additional time to transition out of the start-up environment.

While operating performance improved gradually, the university subsequently realized that additional support would be needed to support VT-ARC's ongoing working capital needs. In response, the university and the VTF jointly developed an additional \$4 million line of credit for VT-ARC, with each entity supporting \$2 million of the line of credit.

Under authorities granted by the Restructuring Act, the Board of Visitors authorized the university to loan VT-ARC up to \$2 million at the November 18, 2013 meeting. This loan was to provide the university's share of the line of credit for VT-ARC's working capital needs during an extended start-up phase. The university has loaned the full \$2 million to VT-ARC.

During fiscal year 2015, VT-ARC continued to obtain sponsored funding, but was unable to generate funding at levels sufficient to cover all operating costs and break even. The corporation continued to rely on draws from the line of credit from the university and the VTF to cover its operating cash flow shortfalls.

In the spring of 2015, the university assessed the operations of VT-ARC and asked the corporation to explore its business options, including a suspension of operations, the sale of all or certain assets, and continuation of current operations. VT-ARC's Board established a subcommittee to explore these options

During fiscal year 2016, as this subcommittee continued its work, VT-ARC continued full operations and relied on the remaining line of credit funding from the VTF to cover its operating cash flow requirements. The work of the VT-ARC subcommittee was completed in June of 2016. The subcommittee supported a proposal to restructure the relationship of the VT-ARC with the university's research programs and to continue operations in an effort to strengthen and grow the impact of VT-ARC on the university's research operations. The work of that subcommittee, and its recommendations, were reviewed with the Finance and Audit Committee of the Board of Visitors during its August 2016 meeting.

As a result, VT-ARC is continuing to operate as a related corporation during fiscal year 2017 and to comply with the requirements of their Affiliation Agreement with the university. The activities to restructure and reinvent VT-ARC are being led by the Vice President for Research and Innovation, working closely with the new CEO of VT-ARC. The university continues to believe that these efforts have a good chance of successfully positioning VT-ARC for long-term success, in support of Virginia Tech's research goals and mission.

Write-off of VT-ARC Note Receivable

As mentioned above, in November 2013, the Board of Visitors authorized the university to loan VT-ARC up to \$2 million to help fund its start-up operations, and the university has loaned the full amount authorized. While VT-ARC has been successful at obtaining sponsored projects, revenue and cash flow has not achieved the level sufficient to breakeven and to repay the loans and related interest expense to the university and the VTF.

As a part of the evaluation of VT-ARC's potential to make significant contributions to the future research initiatives of the university in the National Capital Region, the university recognized that it is very unlikely during the next several years that VT-ARC would be able to obtain sponsored projects to generate cash flow sufficient to repay the loans held by the university and the VTF.

As a result, the university is proposing to write-off the \$2 million note receivable from VT-ARC. In conjunction with the university's proposed action, in October 2016 the VTF wrote-off and discharged all amounts loaned to VT-ARC, with the exception of \$3 million.

The write-off and full discharge of the loans due from VT-ARC to the university and VTF are critical actions in VT-ARC's efforts to improve the financial viability of the organization. The forgiveness of debt by both the university and the VTF, with a portion of the VTF debt restructured to provide a realistic fixed repayment period, will assist VT-ARC to reduce the fixed costs which contributed to the ongoing operating cash flow deficits produced in prior years.

In order for VT-ARC to write-off the note payable to the university from their financial statements as of June 30, 2016, the university must formally discharge the debt owed by VT-ARC.

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WHEREAS, the university's strategic plan envisions the expansion of the research enterprise and the development of innovative and cutting edge technology; and

WHEREAS, the university established the Virginia Tech - Applied Research Corporation (VT-ARC) as a university related corporation to access research opportunities not easily accomplished within the university structure and to leverage the basic and scholarly research performed within the university; and

WHEREAS, the university requested that the Virginia Tech Foundation (VTF) provide the initial capital for operations and specialized facilities improvement with the intent that such funds will be repaid from the future operations of VT-ARC; and

WHEREAS, the university partnered with the VTF to support VT-ARC through the provision of funding from nongeneral fund sources of \$2 million in loans to finance ongoing operations and to provide VT-ARC the opportunity to reach a sustainable level of external grants and contracts funding; and

WHEREAS, VT-ARC has been able to obtain some sponsored funding; however, it is not sufficient to cover operating costs and break-even; and

WHEREAS, based on the work of a committee formed to determine the future of VT-ARC, university management decided that VT-ARC should be restructured because of its potential to significantly contribute to the university's research programs and destination area priorities; and

WHEREAS, forgiveness of debt by both the university and the VTF, with a portion of the VTF debt restructured to provide a realistic fixed repayment period, is needed to significantly improve the financial viability of VT-ARC; and to reduce the fixed costs which contributed to ongoing operating cash flow deficits; and

WHEREAS, under section 23.1-1010 of Restructured Higher Education Financial and Administrative Operations Act of the Code of Virginia the Board of Visitors has the authority to authorize such transactions and also to forgive and fully discharge such loans;

NOW, THEREFORE BE IT RESOLVED, that the Board of Visitors authorizes, at the President's discretion, the negotiation and execution of the agreements to forgive and discharge the \$2 million loaned by the university to VT-ARC for start-up funding plus any accrued interest expense.

BE IT FURTHER RESOLVED, that the Board of Visitors requires the development of a business plan to guide the operations of the VT-ARC for 2016-17 and future years and to strengthen the financial and operational activities of the VT-ARC.

RECOMMENDATION:

That the resolution authorizing, at the President's discretion, the negotiation and execution of the agreements to forgive and discharge the \$2 million loaned to VT-ARC for start-up funding plus any accrued interest expense, be approved.

November 7, 2016