

HOUSTON ENDOWMENT INC.

FINANCIAL STATEMENTS

December 31, 2017 and 2016

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INDEPENDENT AUDITOR'S REPORT

The Board of Directors
Houston Endowment Inc.

We have audited the accompanying financial statements of Houston Endowment Inc. (the Foundation), which comprise the statement of assets and fund balance — federal excise tax basis as of December 31, 2017, and the related statement of revenues, expenditures, and changes in fund balance — federal excise tax basis for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with the basis of accounting used for federal excise tax purposes described in Note 1; this includes determining that the basis of accounting is an acceptable basis for the preparation of the financial statements in the circumstances. Management also is responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and fund balance of the foundation as of December 31, 2017, and its revenues, expenditures, and changes in fund balance for the year then ended in accordance with the basis of accounting described in Note 1.

(Continued)

Federal Excise Tax Basis of Accounting

As described in Note 1 to the financial statements, the financial statements have been prepared by the Foundation on the basis of accounting used for federal excise tax purposes, which is a basis of accounting other than accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matter

The financial statements of Houston Endowment Inc. as of December 31, 2016, were audited by other auditors whose report dated November 6, 2017, expressed an unmodified opinion on those statements.

Crowe LLP

Crowe LLP

Chicago, Illinois
November 5, 2018

HOUSTON ENDOWMENT INC.
STATEMENTS OF ASSETS AND FUND BALANCE – FEDERAL EXCISE TAX BASIS
December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Assets		
Cash, cash equivalents and short-term investments	\$ 72,273,919	\$ 63,004,708
Marketable securities	57,762,581	56,285,686
Other investments	1,229,968,288	1,247,912,791
Real property	323,234	323,234
Other assets	<u>3,745,327</u>	<u>2,927,750</u>
Total assets	<u>\$ 1,364,073,349</u>	<u>\$ 1,370,454,169</u>
Fund balance		
Appropriated for grants payable in future years	\$ 78,800,461	\$ 68,732,918
Unappropriated fund balance	<u>1,285,272,888</u>	<u>1,301,721,251</u>
Total fund balance	<u>\$ 1,364,073,349</u>	<u>\$ 1,370,454,169</u>

See accompanying notes to financial statements.

HOUSTON ENDOWMENT INC.
STATEMENTS OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE –
FEDERAL EXCISE TAX BASIS
Years ended December 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
Revenues		
Realized capital gains, net	\$ 74,497,494	\$ 46,973,091
Partnership income	18,726,000	19,807,979
Royalties and rents	5,564,012	1,942,632
Interest	1,354,340	1,047,391
Dividends	189,654	151,707
Other income	5,077	-
	100,336,577	69,922,800
Expenditures		
Investment expenses	30,622,872	26,257,263
Administrative expenses	8,885,582	6,844,360
Federal excise taxes	440,220	338,116
	39,948,674	33,439,739
Revenues, less expenditures before grant payments	60,387,903	36,483,061
Grant payments	66,817,537	65,136,314
Grant refunds	(48,814)	(2,134,975)
Excess of expenditures over revenues	(6,380,820)	(26,518,278)
Fund balance at beginning of year	1,370,454,169	1,396,972,447
Fund balance at end of year	\$ 1,364,073,349	\$ 1,370,454,169

See accompanying notes to financial statements.

HOUSTON ENDOWMENT INC.
NOTES TO FINANCIAL STATEMENTS
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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity: Houston Endowment Inc. (the Foundation) was incorporated in 1937 as a nonprofit organization for the purpose of supporting charitable, educational, and religious undertakings. The Foundation invests its endowment funds and uses the return from the investments to make grants to charitable organizations.

Basis of Accounting: The Foundation reports on the federal excise tax basis of accounting which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. Revenues are recognized when cash is received or recognized for tax purposes, and expenditures are recognized when cash is disbursed or recognized for tax purposes. Accordingly, direct charitable activities and grants to charitable organizations are recognized as expenditures when paid. Accounts do not include interest and dividends receivable, pension liability, federal excise tax payable, or other liabilities, unless subject to federal excise tax in the current period. Purchases or sales of investments are recorded at trade date, with payables or receivables from such transactions reflected as settled in cash on the trade date. Unrealized gains and losses on investments are not recorded except where required for tax purposes.

Cash, Cash Equivalents and Short-Term Investments: The Foundation considers all highly liquid investments having original maturities of three months or less to be cash equivalents and all investments having original maturities of one year or less to be short-term investments. The Foundation maintains its cash in bank accounts which, at times, may exceed federally insured limits. The Foundation has not experienced any losses in such accounts. Management believes that the Foundation is not exposed to any significant credit risk on cash.

Marketable Securities: Marketable securities are recorded at cost on the date of acquisition.

Other Investments: Other investments include nonmarketable securities, such as limited partnerships of private equity, real estate and alternative investments, and are recorded at cost on the date of acquisition. As of December 31, 2017 and 2016, 49% and 45%, respectively, of the portfolio was held in vehicles utilizing lock-ups of 12 months or shorter and 69% and 78%, respectively of the portfolio was held in vehicles utilizing lock-ups of 60 months or shorter.

As of December 31, 2017 and 2016, the Foundation held investments under the direction of various fund managers, with the largest concentration of investments managed by Investure. Investments at cost managed by Investure as of December 31, 2017 and 2016 were as follows:

	<u>2017</u>	<u>2016</u>
Investure Global Equity Fund, LP	\$ 289,464,833	\$ 345,920,347
Investure Emerging Markets Fund, LP	135,981,533	126,820,881
Investure Evergreen Fund, LP	224,123,290	202,184,956
Investure Alternative Fund, Ltd.	330,159,794	325,302,550
Investure PE Fund, LP	43,383,109	17,515,271
Parametric Global Equity	<u>7,945,010</u>	<u>8,998,918</u>
Total investments managed by Investure	<u>\$ 1,031,057,569</u>	<u>\$ 1,026,742,923</u>

(Continued)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Other than the investments listed above, there were no investments held by the Foundation that represented more than 5% of the Foundation's fund balance as of December 31, 2017 and 2016. The Foundation had unfunded commitments to make additional partnership investments of approximately \$305 million at December 31, 2017. The timing of the funding of such commitments will vary from year to year based on the specific capital requirements of the partnerships.

Derivative Instruments: The Foundation enters into certain over-the-counter and exchange-traded derivative instruments which may be employed for a variety of purposes but for which unlimited liability is prohibited. The Foundation recognizes investment income or loss when cash is received or disbursed in accordance with the underlying contract along with unrealized gains and losses as required under the federal excise tax basis of accounting. The notional exposure to equity index futures totaled \$30,500,590 and \$7,376,115 at December 31, 2017 and 2016, respectively.

Real Property: Investments in real property are recorded at cost.

Other Assets: Other assets (including leasehold improvements, furniture, equipment, and software used in the operations of the Foundation) are recorded at cost. Where appropriate, these assets are depreciated using the straight-line method based on their estimated useful lives.

Fund Balance: Grants approved to be paid in a future year are reflected as appropriated fund balance until paid. Unappropriated fund balance includes the amount of the original endowment, gains recognized on sales and other dispositions of assets, and excess of expenditures over revenues.

Federal Excise Taxes: The Foundation qualifies as a tax-exempt organization under Section 501 of the Internal Revenue Code of 1986 and, accordingly, is not subject to federal income tax. However, the Foundation is classified as a private foundation and is subject to an excise tax on net investment income. For 2017 and 2016, the Foundation incurred excise taxes at the rate of 2% of net investment income.

Consistent with the federal excise tax basis of accounting, federal excise taxes are recorded when estimated payments are made, final payments are made, or refunds are received. Accordingly, federal excise tax expense on the statements of revenues, expenditures, and changes in fund balance may be substantially more or less than the actual tax attributable to any individual year.

Reclassifications: Certain reclassifications have been made to prior year amounts to conform to the current year presentation. These reclassifications had no effect on the change in fund balance.

NOTE 2 - RETIREMENT BENEFITS

The Foundation has a defined-benefit pension plan covering its employees. The Foundation made contributions of \$600,000 in 2017 and 2016. The defined-benefit pension plan is funded in amounts sufficient to meet the minimum requirements of the Employee Retirement Income Security Act of 1974. As of October 1, 2017, the date of the latest actuarial valuation, the Adjusted Funding Target Attainment Percentage, as defined by the Pension Protection Act of 2006, was 106%.

The Foundation also has a voluntary defined-contribution plan that provides retirement benefits to participating employees. Employees are eligible for participation upon completion of 30 days of continuous service. The Foundation's contributions are based upon a percentage of employee contributions. The Foundation's contributions to the plan were \$122,579 and \$128,475 in 2017 and 2016, respectively.

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NOTE 3 - LEASE OBLIGATIONS

In 2017 and 2016, the Foundation paid approximately \$635,000 and \$575,000 in lease payments, respectively, for office space. Future minimum rental payments under the non-cancelable operating lease for office space for the next five years and thereafter are as follows:

Year ending December 31:

2018	\$ 677,934
2019	684,187
2020	632,872
2021	696,700
2022	464,715
Thereafter	<u>-</u>
Total	<u>\$ 3,156,408</u>

NOTE 4 – GRANTS APPROPRIATED FOR PAYMENT IN FUTURE YEARS

As previously noted, grants approved are recorded as appropriated fund balance until paid and they are recognized as expenditures when paid. Grants appropriated for payment in future years as of December 31, 2017 and 2016, were as follows:

	<u>2017</u>	<u>2016</u>
Appropriated for grants payable in future years at beginning of year	\$ 68,732,918	\$ 72,181,927
Grants approved	76,885,080	61,687,305
Grants paid	<u>(66,817,537)</u>	<u>(65,136,314)</u>
Appropriated for grants payable in future years at end of year	<u>\$ 78,800,461</u>	<u>\$ 68,732,918</u>

The Foundation estimates that the appropriated for grants payable in future years balance as of December 31, 2017 will be paid as follows:

Year ending December 31:

2018	\$ 46,371,125
2019	13,948,249
2020	16,046,058
2021	1,685,029
2022	<u>750,000</u>
Total	<u>\$ 78,800,461</u>

(Continued)

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NOTE 5 – DIRECT CHARITABLE ACTIVITIES

Direct charitable activities occur when a foundation conducts exempt activities itself, rather than through a grantee organization. In 2017 and 2016, the Foundation spent \$1,600,000 and \$200,000, respectively, on direct charitable activities. These expenditures are included in the amount reported as “administrative expenses” on the Statements of Revenues, Expenditures, and Changes in Fund Balance.

NOTE 6 - SUBSEQUENT EVENTS

The Foundation has evaluated subsequent events through November 5, 2018, the date the Foundation's financial statements were available for issuance.

NOTE 7 – FAIR MARKET VALUE OF ASSETS (Unaudited)

The statements of assets and fund balance and the related statements of revenues, expenditures, and changes in fund balance do not include any unrealized gains or losses due to changes in the fair market value of assets.

At December 31, the fair market value of the Foundation's assets is as follows:

	<u>2017</u>	<u>2016</u>
Cash, cash equivalents and short-term investments	\$ 72,274,730	\$ 63,004,796
Marketable securities and related receivables	58,731,902	54,846,187
Other investments	1,683,171,112	1,538,392,711
Real property	40,268,737	27,751,321
Other assets	<u>3,758,310</u>	<u>2,944,446</u>
 Total assets	 <u>\$ 1,858,204,791</u>	 <u>\$ 1,686,939,461</u>

Fair market values of marketable securities and short-term investments are based upon published quotations. Receivables are stated at the accrued amount. The fair market value of other investments and assets is determined by management.

The value of real property is determined by independent appraisers and is updated at least every five years.