A Business Model For Nature Pointe

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Finance Committee:
Veronica Montano-Pilch, Treasurer
Gary Clark, Martin Pilch, Heidi Ruffner, Eric Schindwolf

January 29, 2017
Nature Pointe Clubhouse

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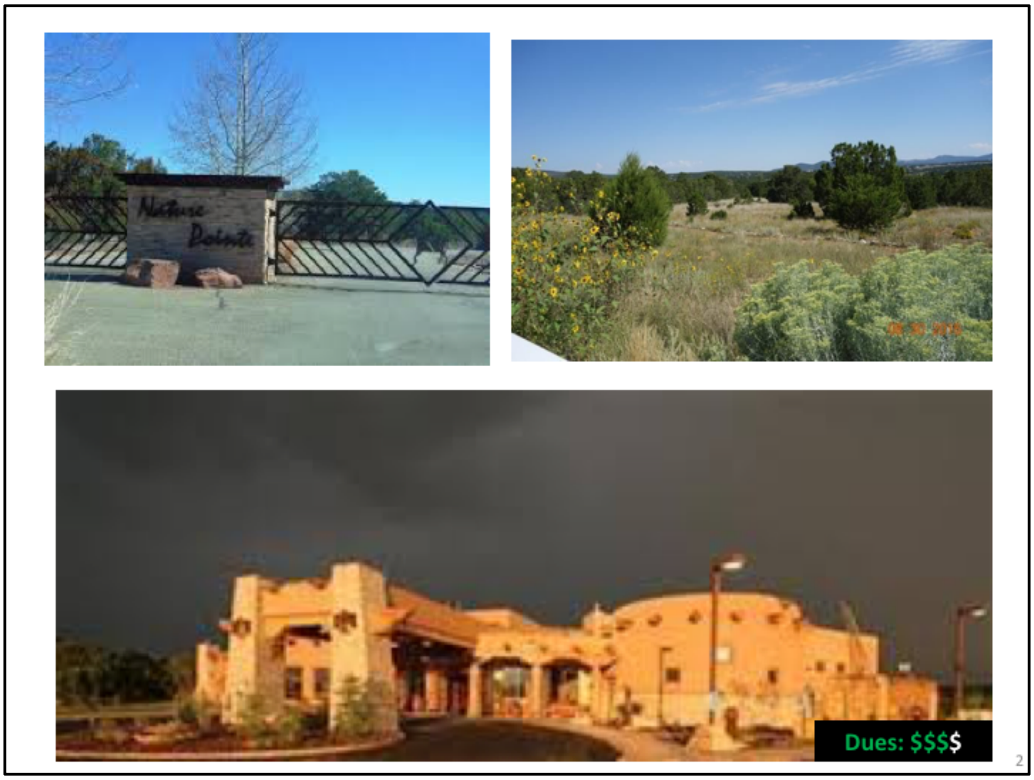
A personal note on who I am

Husband to Veronica (Board member), 6 kids (1 at home, 3 more in town), 11 grand kids (6 in town), mother in law (lives with us), and 2 dogs

We've lived in the community about 19 months, 6 in the shop apartment while waiting for our new construction retirement home to be completed
Lot 90 26 Mustang Mesa Trail

We're vested in the community and willing to share skills and experience to make it successful

Ground Rules:
I'll answer questions of clarification in real time
More general questions or comments or topics for discussion should be sent to the parking lot (managed by Veronica)
Veronica will mediate the Q&A period at the end



Premier gated community in the East Mountains with a truly unique clubhouse and relatively low HOA dues

Resort living at home
More amenities than you can count on your fingers
Reliable (Entranosa) water, reliable (PNM) electricity, and ~ high speed internet
Convenient access to Albuquerque
What more could you want?

WE WANT ASSURANCE THAT THIS IS SUSTAINABLE

What is a business model?

- **Documented and transparent strategy to ensure long-term viability of NP HOA i.e., no special assessments**
  - Analyze cash flow and cash reserves with a 30 year planning horizon
  - Use the model to analyze various scenarios and trade-offs to better inform the community and Board decisions

The NP Business model is an Excel workbook

- **Key inputs**
  - All historical Profit and Loss Statements and supporting details in QuickBooks (i.e., our accounting software)
  - Reserve Study performed by Association Reserves in 2014
    - Email communications with Robert Nordlund CEO/Founder and phone conversations with Will Schafer (Reserve Specialist)
    - Website educational literature and webinars
  - Documented cost/benefit analysis for road maintenance
- **Supporting data documented in separate worksheets**
  - All scenario options, all cost and useful life estimates, all historical P&L statements, historical inflation data, historical new housing starts for the SW, HOA dues comparison data, key cost/benefit analyses
- **Math in an earlier version verified by Dan Sprauer**

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Why am I qualified to do this?

PhD Nuclear Engineering
Retired from Sandia in Feb 2016 after 35 years
Worked on commercial nuclear power reactor safety and “national security types of issues”
Lab leadership in risk assessment for high consequence systems
Directly managed research programs in the $15M to $25M range and deputy to a $110M program
Certified as a Project Management Professional by the Project Management Institute

Why a business model?

"We can't manage it unless we know what *it* is"
-Marty Pilch-

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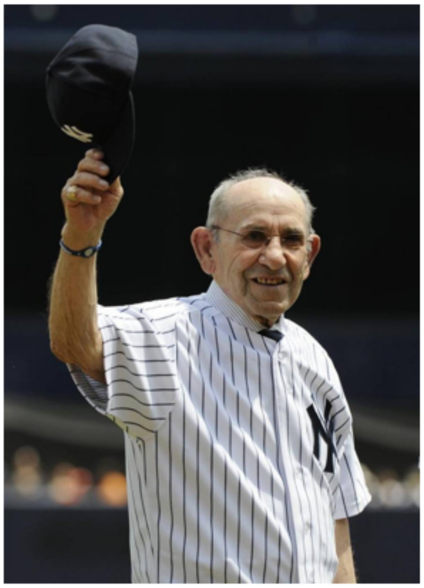
30 year planning horizon?????



"It's tough to make predictions, especially about the future"
-*Yogi Berra*-

But

"If you don't know where you are going, you might end up someplace else"
-*Yogi Berra*-

Avoid special assessments!

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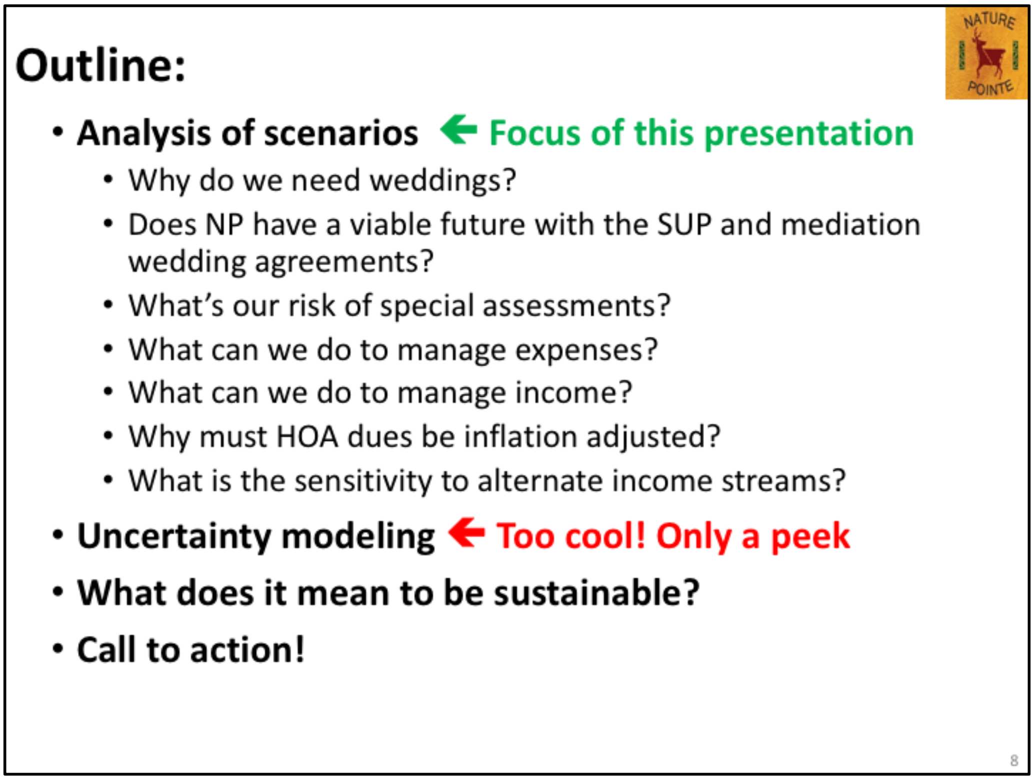
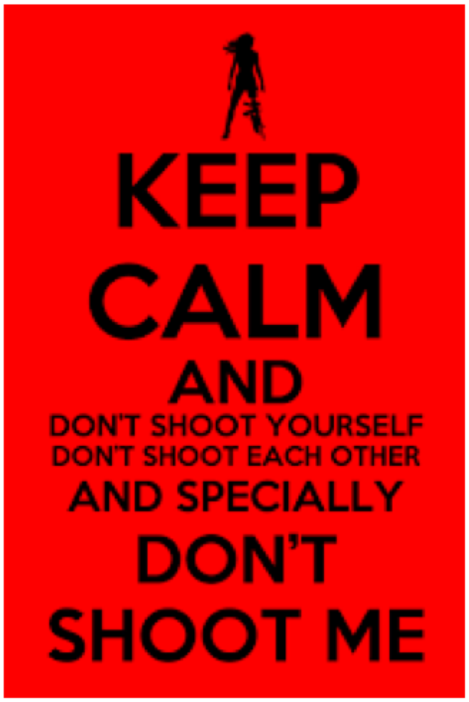
Assumption check:

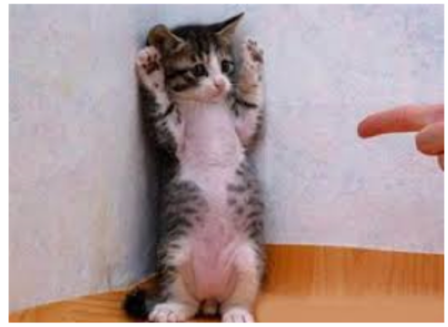
Can we agree
that from a HOA and homeowners perspective
that special assessments are unfair and to avoided?

Would the developer have a different perspective?

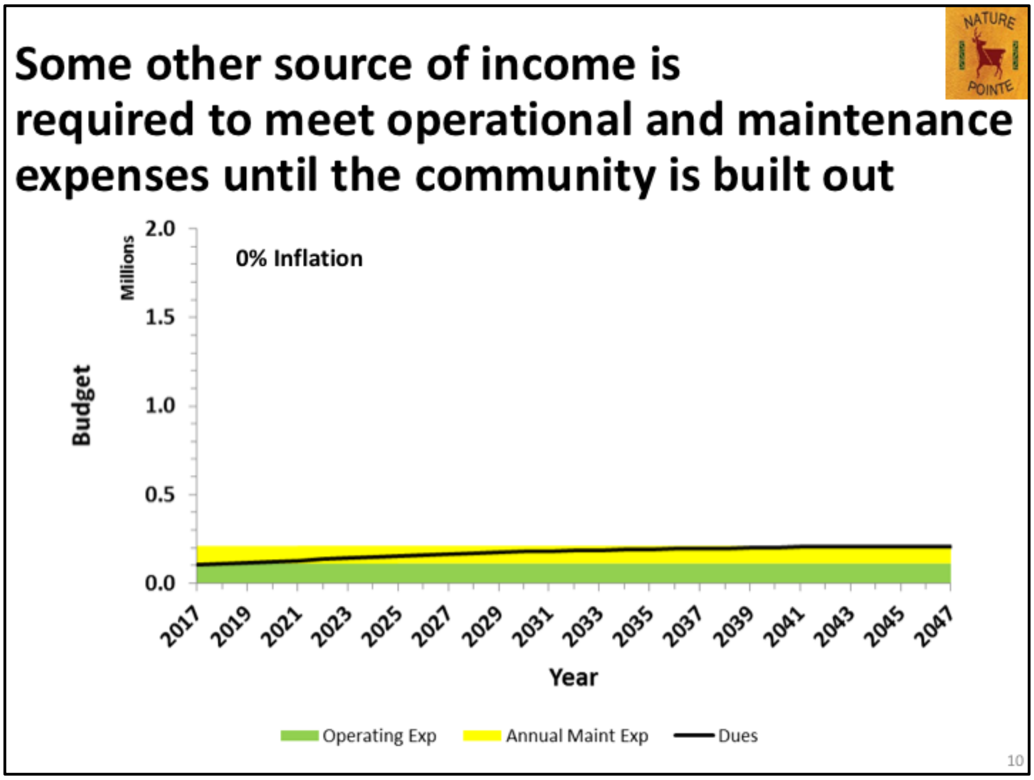


Tell a story through the evolution of various scenarios


KEEP
CALM
AND
DON'T SHOOT YOURSELF
DON'T SHOOT EACH OTHER
AND SPECIALLY
DON'T
SHOOT ME



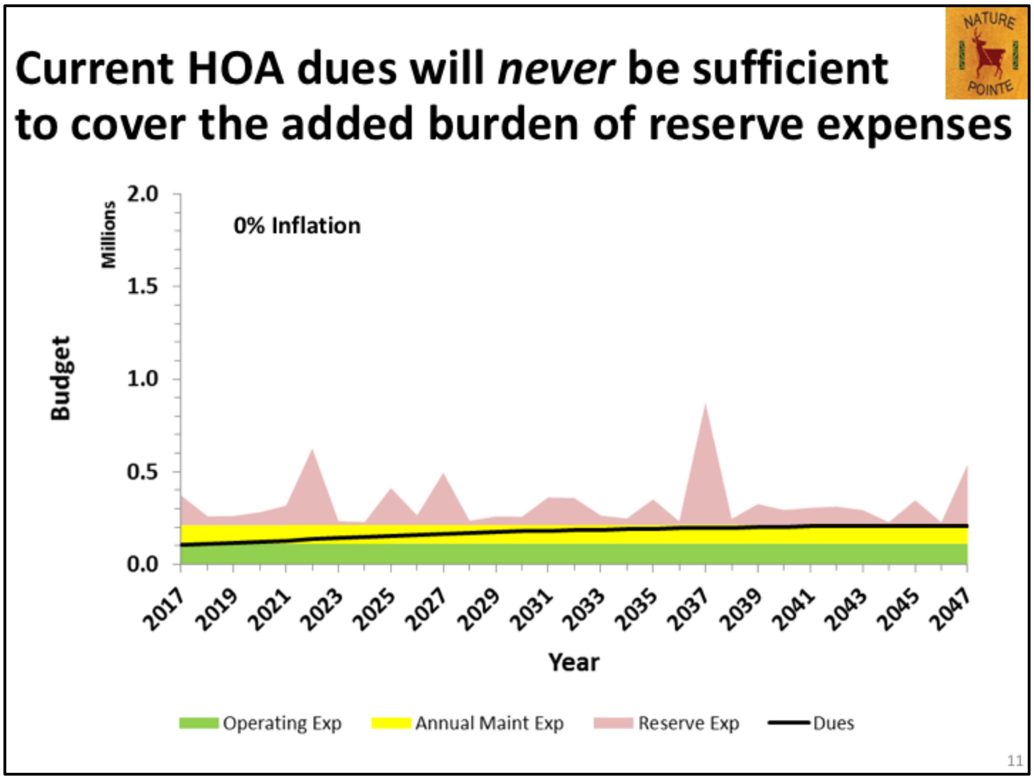

Marty
HOA



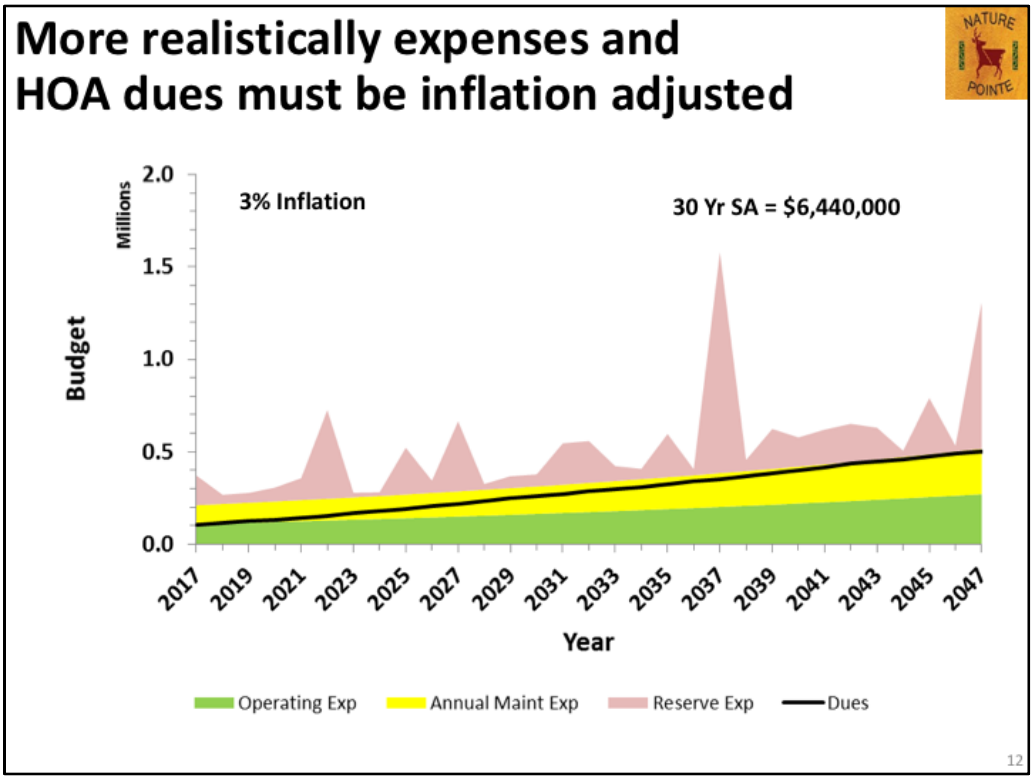
Dues only, no weddings, no rental income

Current development status
29 homes, 42 sold lots w/o homes, 41 unsold lots, 22 of which are not developed

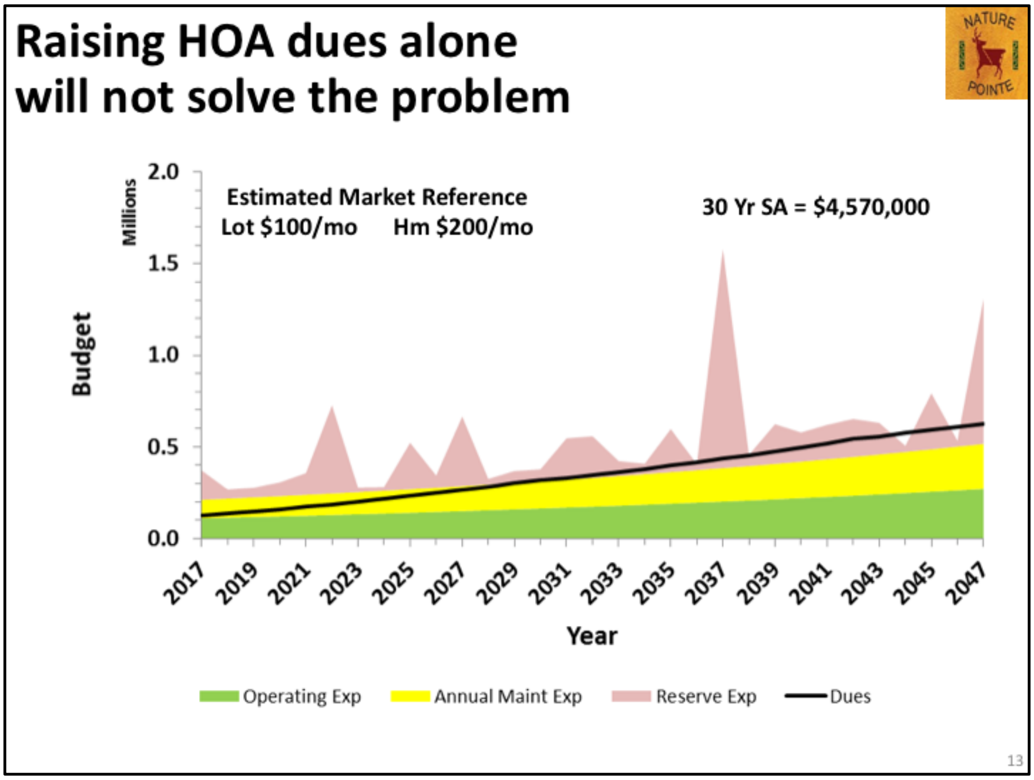
Assumption: sell 3 lots/yr cap 107 build 3 lots/yr cap 104
Community built out in ~25 years (2042)



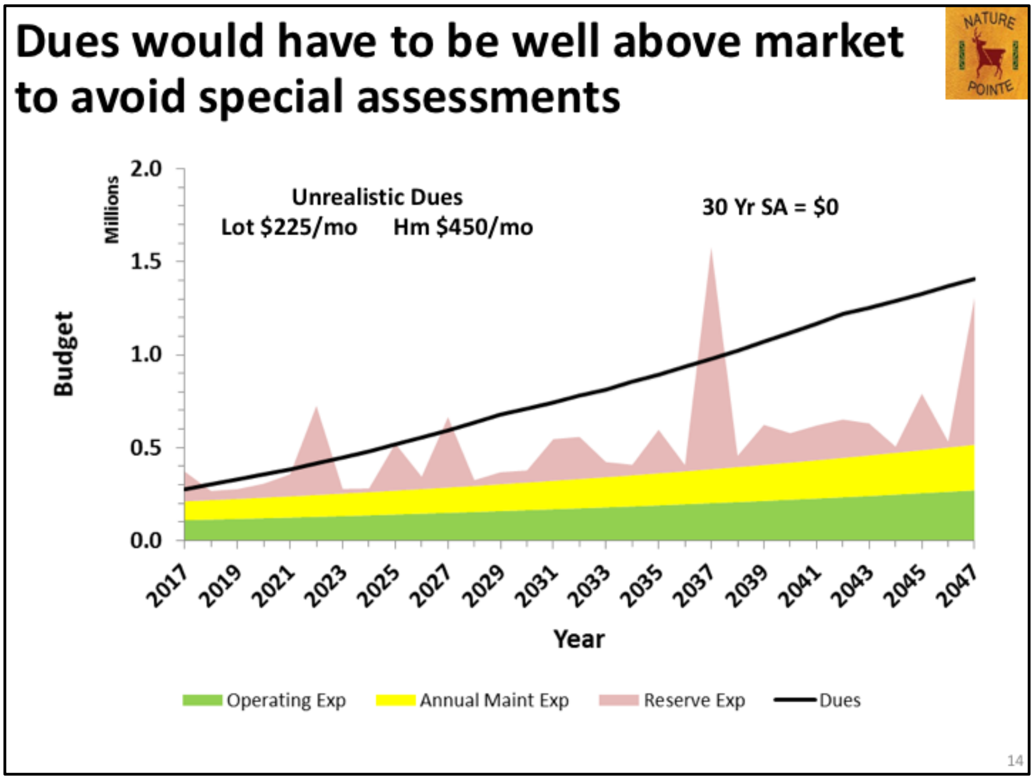
Reserve expenses cover deterioration and replacement of assets
Expenses occur infrequently and often are big ticket items
Tend not to think about these things e.g., resurfacing of roads, reroofing the clubhouse, replacing the evaporative coolers, etc



AR used 3%
Yes inflation has been <2% the last couple of years
But if you are going to make 30 predictions, you want to use a number representative of the 30 year average
That's about 3%



Market reference based on comps that I and another member did a couple of years ago
Admittedly a difficult assessment because there is nothing exactly like Nature Pointe
We have 3 realtors in the community, help us update this important assessment
I only ask that document the basis of your assessment because if its not documented, it does not exist



At these dues you just skate by if all of dozens of assumptions hold true
If there is any deviation of any of the assumptions, then the likelihood of SA increases dramatically at these threshold dues

There is only one reason to have weddings at Nature Pointe

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Includes corporate events

Wedding in the short term are needed to cover shortfalls in operational and annual maintenance activities
And for all time to cover reserve expenses

Baseline: Where we are today, more or less

- **Management reserve $50,000**
- **Effective reserve fund $239,020 today**
  - All sources of income and expenses feed/deplete this pool of money
  - Special assessment required if this pool goes negative in the future
- **Community growth assumptions**
  - Sell 3 lots/year, build 3 lots/year, with caps, built-out 25 years
- **Income inflation adjusted (3%/yr)**
  - Rent shop and clubhouse apartment
  - Wedding income constrained by SUP/mediation agreements
  - Dues at todays rates ($160-home; $90-lot)
  - Investment rate on reserve fund 0.11%
- **Expenses inflation adjusted (3%/yr)**
  - Clubhouse manager about half time
  - Full time maintenance person plus half time help
  - Reserve expenses per Association Reserves with some modifications for reality
  - Deferred road maintenance
  - Wedding expenses up following mediation agreement
  - State and federal income taxes on net income i.e., all HOA income – all HOA deductions

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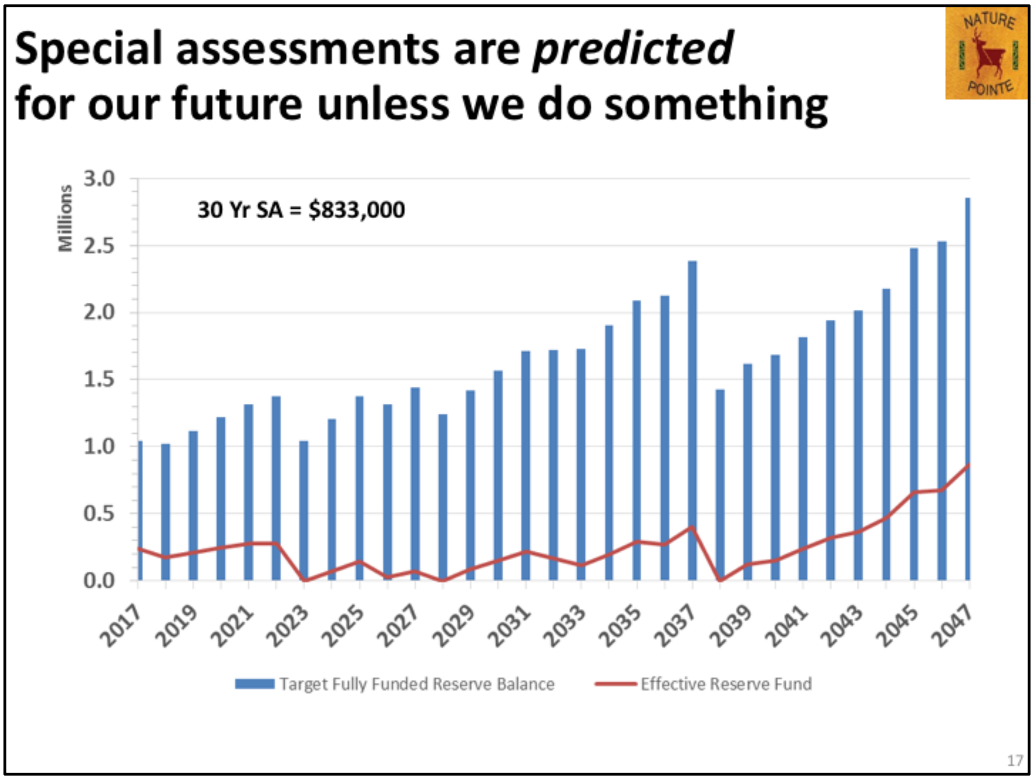
Management reserve:
$50K is about 12% of CY2016 budget. The typical DoD program MR is between **5%-15%**.
By definition, not part of the cost baseline
Used to address "surprise" i.e., the unknown-unknowns (for instance, our current problem with Kitec plumbing fixtures)
In the case of NP, also provides a little cushion for misalignment in the time of cash flow

Effective reserve
Best practice is to segregate operational accounts (including annual maintenance) from reserve accounts
We don't that
We do have something we call a reserve account, but mostly it is something we point to a say, "see, we have a reserve account, and we put money into it this year"
Our reserve account is restricted to capital expenditures (for instance, we can't use it for legal expenses)
Sometimes we throw caution to the wind and buy CD's to get a slightly higher interest rate
Up to now, the community has been young and did not have much in the way reserve expenses, and when we did, we paid them out of operational accounts

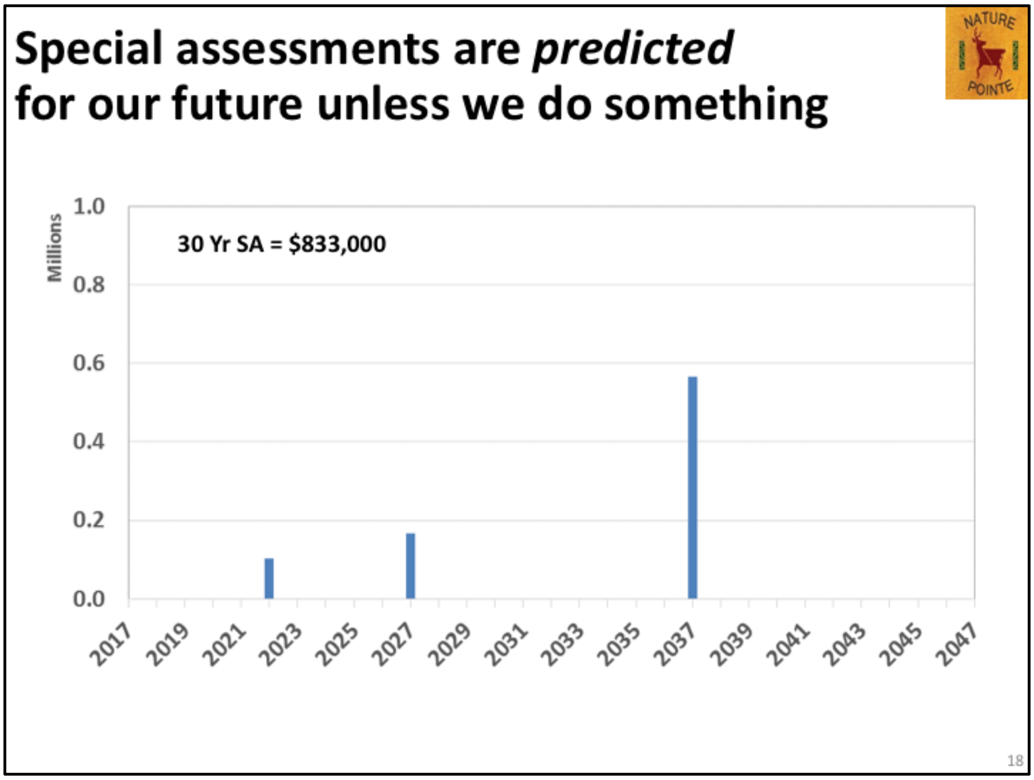
For the purpose of this exercise, we define our effective reserve to mean the total of all our cash accounts – management reserve – unaccrued moneys

Growth assumption
Not 112 lots with homes, but something less and more realistic
107 lots sold and 104 homes
Some lots might be held by the developer, some are not desirable, Horton's might not subdivide
Some lot owners might not build: privacy, investment

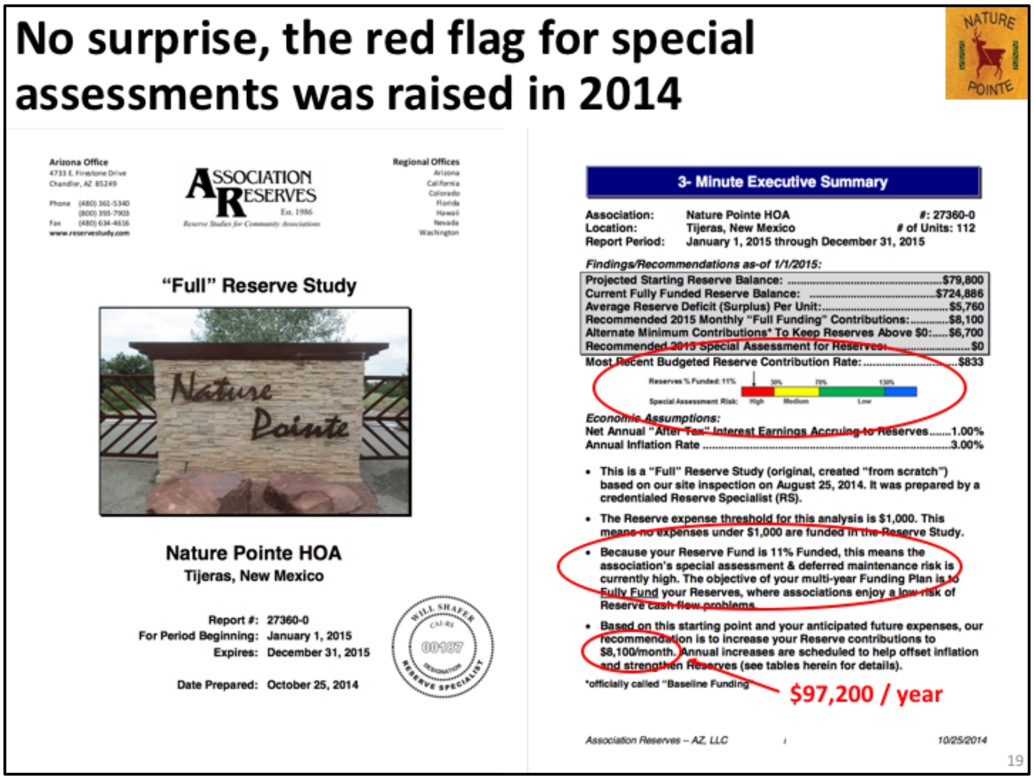


Emphasize “Predicted”
That may or may not be reality depending on how reasonable the all the model inputs are

Target fully funded reserve balance
That's the money we should have in our reserve account to cover reserve expenses when they come due
We’re way short of that target resulting in SA in 2023, 2028, 2038
The red line doesn’t dip below zero because the SA’s bring it back to zero



Key assumptions: all the assessments are correct



Association Reserves is an accredited organization that has performed over 25,000 reserves studies

They gave us an important wakening call. The results and recommendations stunned those in the know. The conclusions came as a shock
I've seen no evidence that the study has been used to guide decisions of the HOA.
I think the sentiment was to dismiss the study outright because they saw room to argue with some of the assessments

I have a totally different perspective.
AR gave us an import tool (they actually gave us a functional spreadsheet), the concepts and math are simple
They gave us a starting point: a fairly detailed component list, useful life for each component, and replacement cost estimates
We are now fully capable of performing calculations directly in NP Business model. No need to further contract with AR

I've read the educational literature on their web site, I've participated in several of their educational webinars.
I understand the motivation and philosophy of AR
The reserve study is only as good as its inputs
I've talked to Will Shafer directly. He performed our reserve study

I’ve had email exchanges with Robert Nordlund PE,RS Founder/CEO of Association Reserves
I understand the origins of some of the more “anomalous” entries in the reserve study
I feel we are justified changing entries if we have a documented justification based on local data, operational experience, or an agreed upon strategy to lower costs or reduce maintenance

As a starting point, NP business model includes several such changes, sometimes to our benefit, sometimes not, but always more realistic
Others will be changed as part of our proposed management strategy

What's under the hood of a reserve study?

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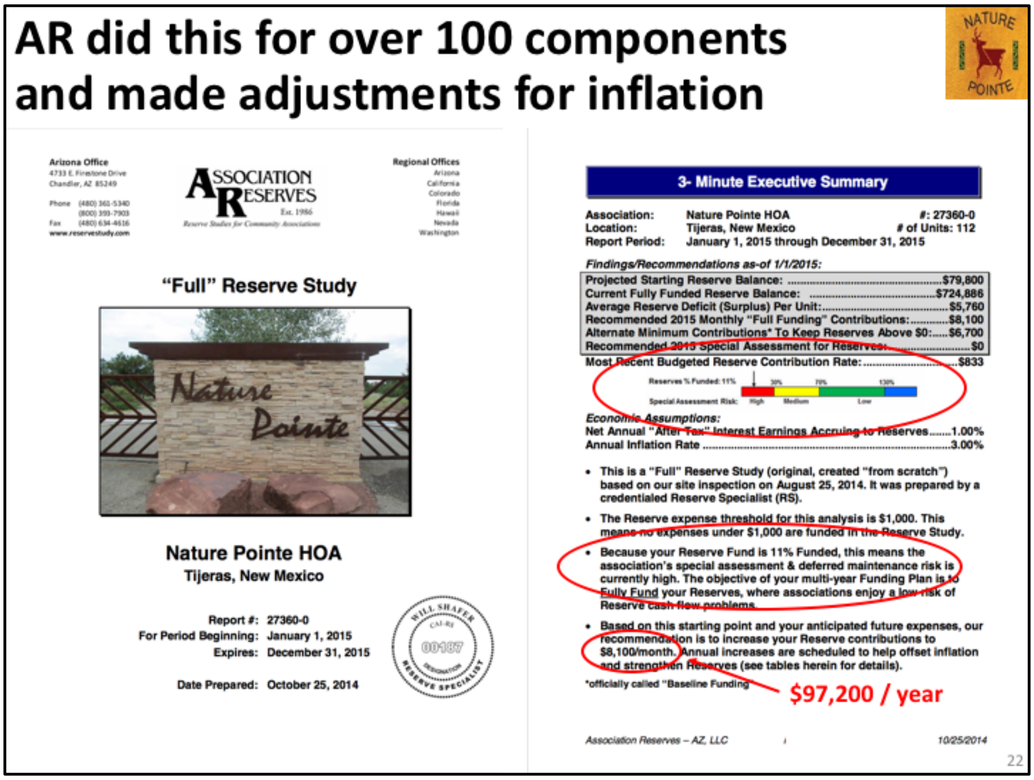
Reserve funds need to be set aside to cover annual deterioration and replace assets when their useful life has expired

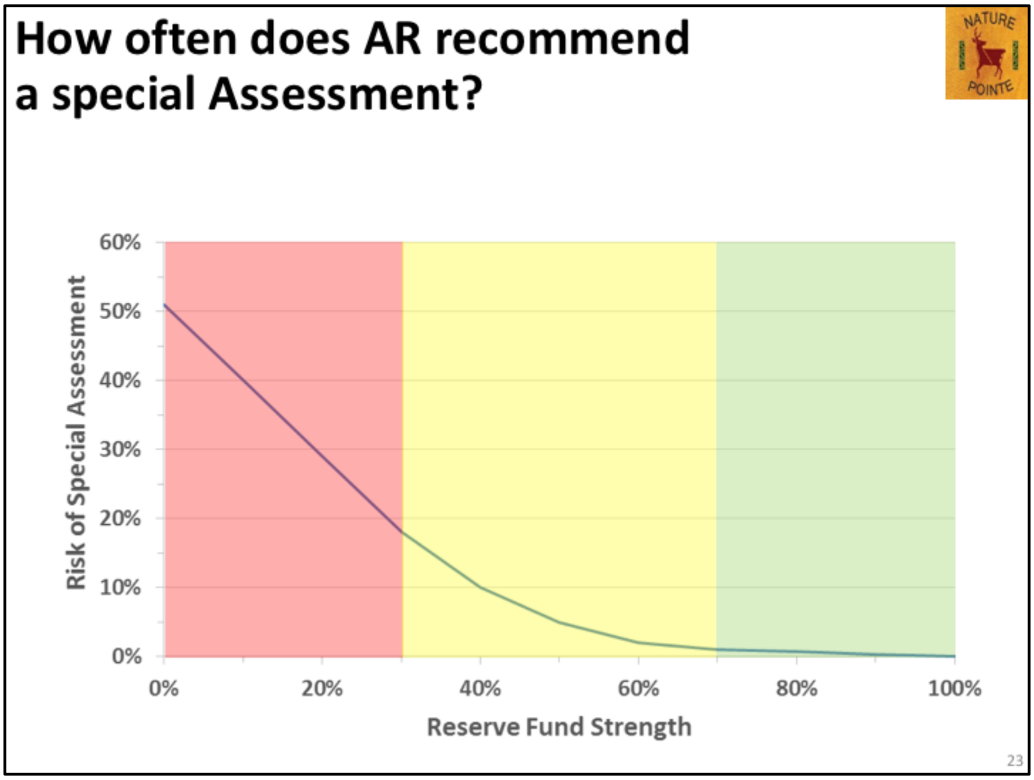
- **Component:** Family car
- **Replacement cost:** $30,000 (no salvage value)
- **Useful life:** 10 years
- **Reserve contribution:** you need to save $3,000/yr in order to replace the car when its useful life has expired
- **Fully funded reserve balance:** After 3 years, you should have $9,000 in your reserve fund
- **Reserve fund strength:** If you have only $900 in the reserve fund, then your reserve fund strength is 10%
- **Plan:** Save more, replace with used car (i.e., change expectations), borrow from kids college fund, or demand a "contribution" from family members (i.e., special assessment)



We have significantly expanded their capabilities

AR knew nothing about what income NP could realistically generate and AR knew nothing about operational shortfalls.
We've produced a more holistic assessment by integrating the reserve calculations into a model that includes our income streams and our operational/maintenance costs

We're in the process of implementing a capability to perform thousands of scenarios with different combinations of uncertain inputs



Question we want answered: what is the risk of a SA in the future based on todays RSF and an operational plan going forward

Risk curve based on over 25,000 reserve studies performed by AR
NP RSF=11% so SA risk about 38%. AR did not recommend a SA because NP had time to increase savings before major reserve costs were needed

This curve has to do with how often AR recommends a SA looking ahead a year or two when commissioned to do a reserve study
It DOES NOT represent the likelihood that our HOA will have a SA at any time in the future based on its reserve fund strength today and a funding plan

AR recommends a target reserve fund strength of 100%, but they rarely recommend SA if the reserve fund strength is over ~60% or 70%

Question: If your HOA has no money in the bank (i.e., the reserve fund strength is zero), how come the risk of special assessment is only 51% and not 100%
Answer: The curve has nothing to do with the risk of your HOA having a special assessment at some time in the future based on the reserve fund strength today. It has to do with how often AR recommends a SA when they commission a reserves study. If a HOA is relatively young when it commissions a reserve study and major reserve expense are far in the future, they have time to implement AR recommendations and

bring their reserve fund up to par. Of course, if a HOA has a reserve fund strength of 0% and they have a major reserve expense next year, the probability of a SA next year is 100%, not 51%


NP
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Do nothing is always an option…

But it will still hurt and likely makes things worse!

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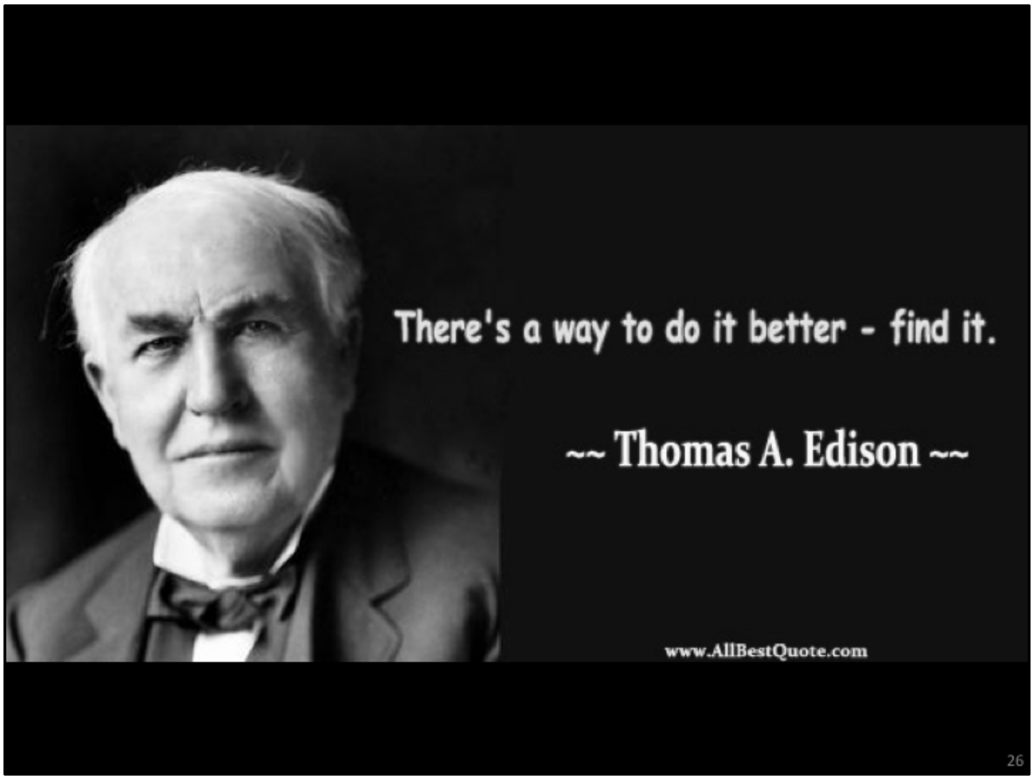

I’ve focused on managing with the current state as a starting point
I have not considered out-of-the-box ideas
I would encourage everyone to think creatively
There may be an even better way yet!

Manage expenses that matter

	30 Yr Savings
• **Manage operational expenses**	
• Embrace 5% utility conservation	$ 89,000
• Transition legal from conflict to operations	$650,000
• Transition wedding mgmt. to commission basis	$495,000
• **Manage maintenance expenses**	
• Reduce maintenance helper	$616,000
• **Manage reserve expenses**	
• Manage roads	$170,000
• Dedicate Aveneda Alegre to county	
• Execute recommended maintenance	
• Replace synthetic stucco with elastomeric paint	$109,000
• Replace playground with modest option	$400,000
• Refurbish fitness center rather than replace	$275,000
• Install or replace anode bags on propane tanks	$ 36,000
• Replace/refurbish furniture tbd	
	$2,840,000

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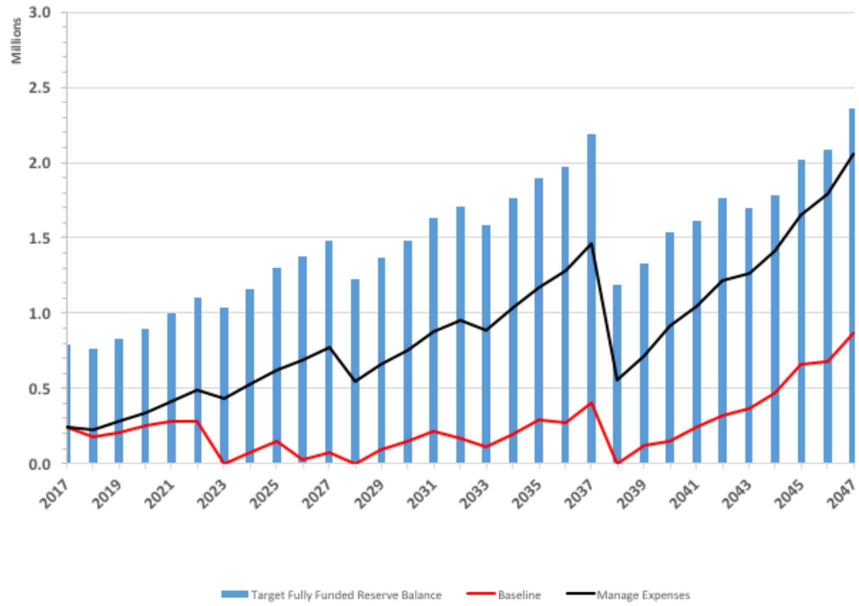
Start with big ticket items in the model
Listen to what community members suggest

Conservation: comes from the community
Legal: save $13/yr
Wedding commission basis: reduce fixed costs as # weddings declines so profit margin is maintained
Maintenance helper: 22hr/wk to 4 hr/wk at $12/hr
Roads: sealcoat based on Star quote from last year
Stucco: $85K UL=22yr to $30K UL=12yr
Playground: $70K UL=10 yr (was 35) to $25K UL=15yr
Fitness center: $138K new to $53K refurbished
Propane tanks: AR $18K UL=20 no maintenance to $12K UL=30 replace bag every 5 yr at $1K

Managing expenses that *matter* gives NP a viable future



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Manage income

- Invest cash reserves a little more boldly (~2%)
- Sell member weddings at cost + $1000
- Adjust member event fees for past inflation (~$6/person)

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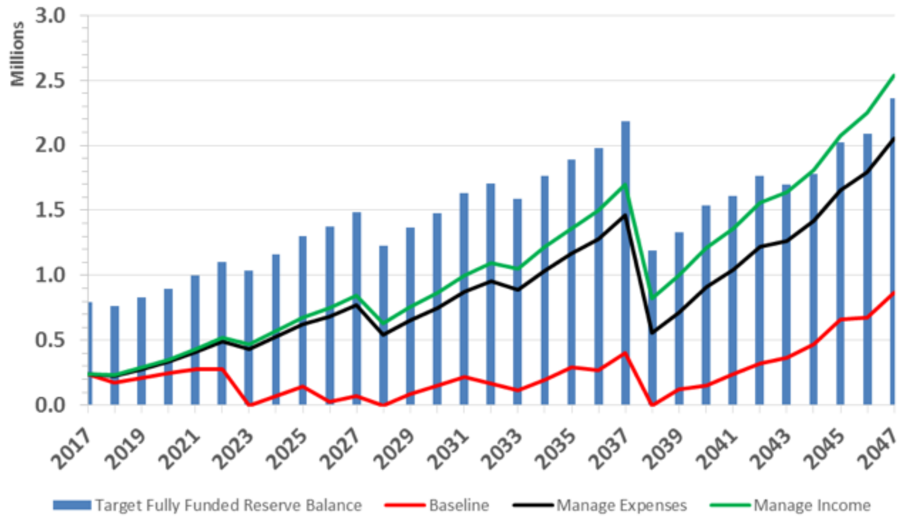
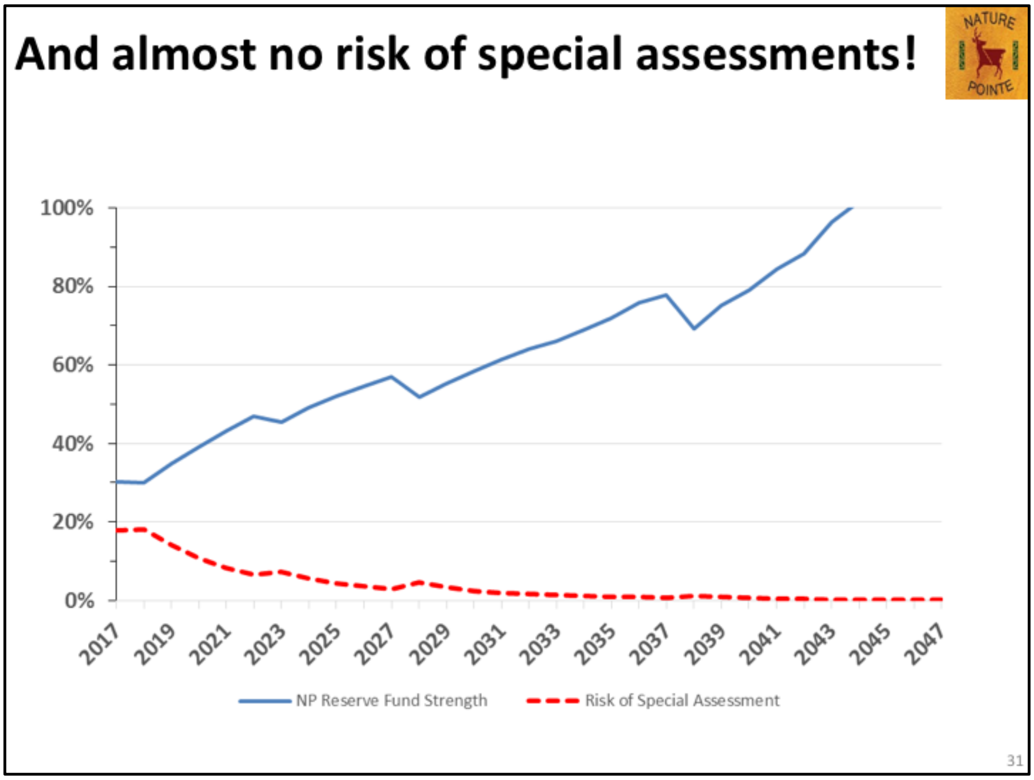
This assumes that you first did the best you can managing expenses per previous slide

Member weddings: “cost” includes wear and tear at the normal $6/head per normal rules. In the past, I’m not sure we’ve recovered true cost + wear and tear for weddings

Adjust member event fees for inflation. Same criteria as in the past
However, I believe that we should review the entire pricing structure for member events and member weddings. Cost + wear and tear should be the operating principle unless the facility (or parts of the facility) are restricted from use by other members. Then members should pay a premium based on how much restriction and for how long.
The second principle is that pricing should still be bargain
Just food for thought

NP *can* achieve
a fully funded reserve balance….




And almost no risk of special assessments!
NATURE
POINTE
100%
80%
60%
40%
20%
0%
2017
2019
2021
2023
2025
2027
2029
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2045
2047
NP Reserve Fund Strength
Risk of Special Assessment
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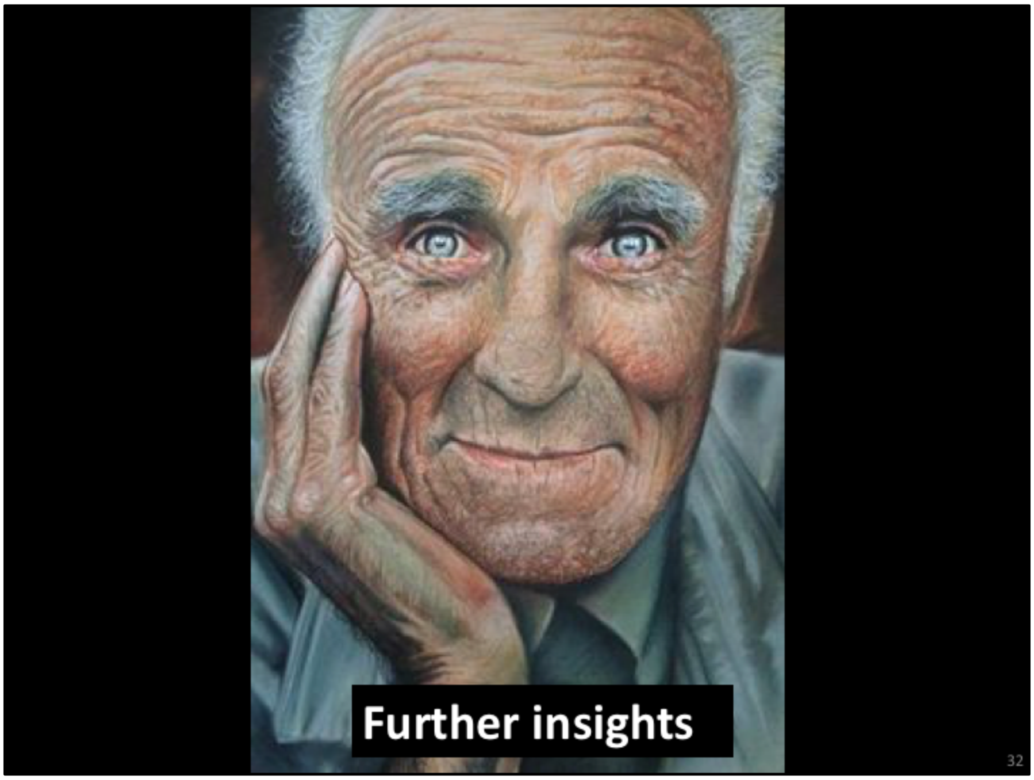
Further insights
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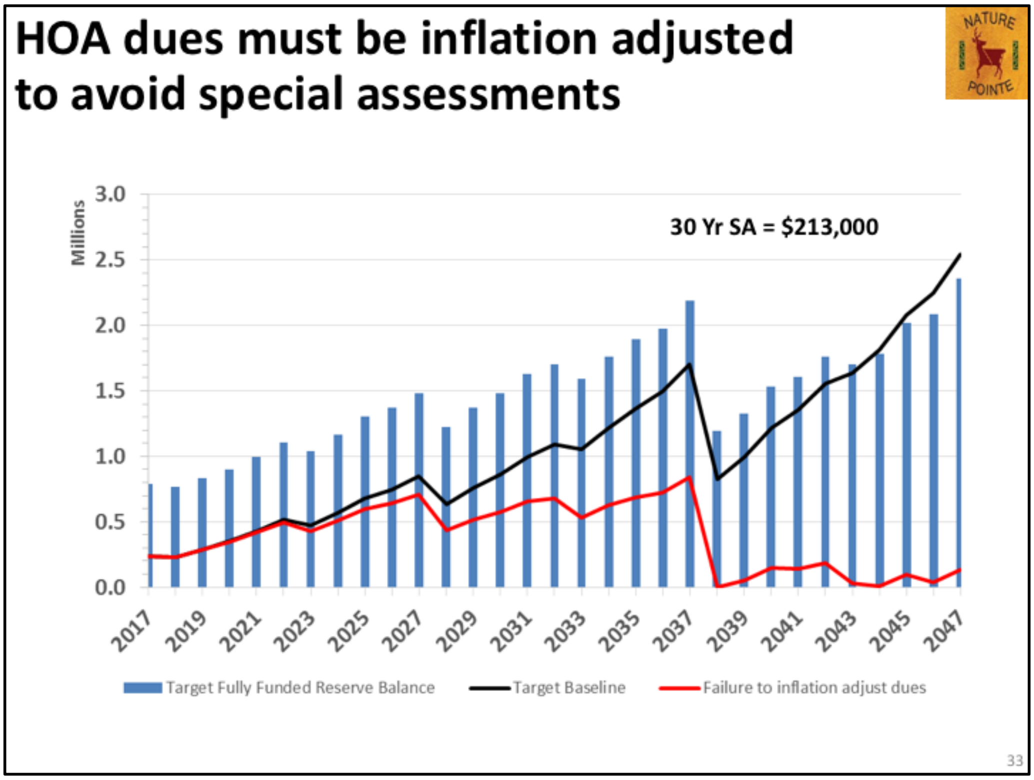
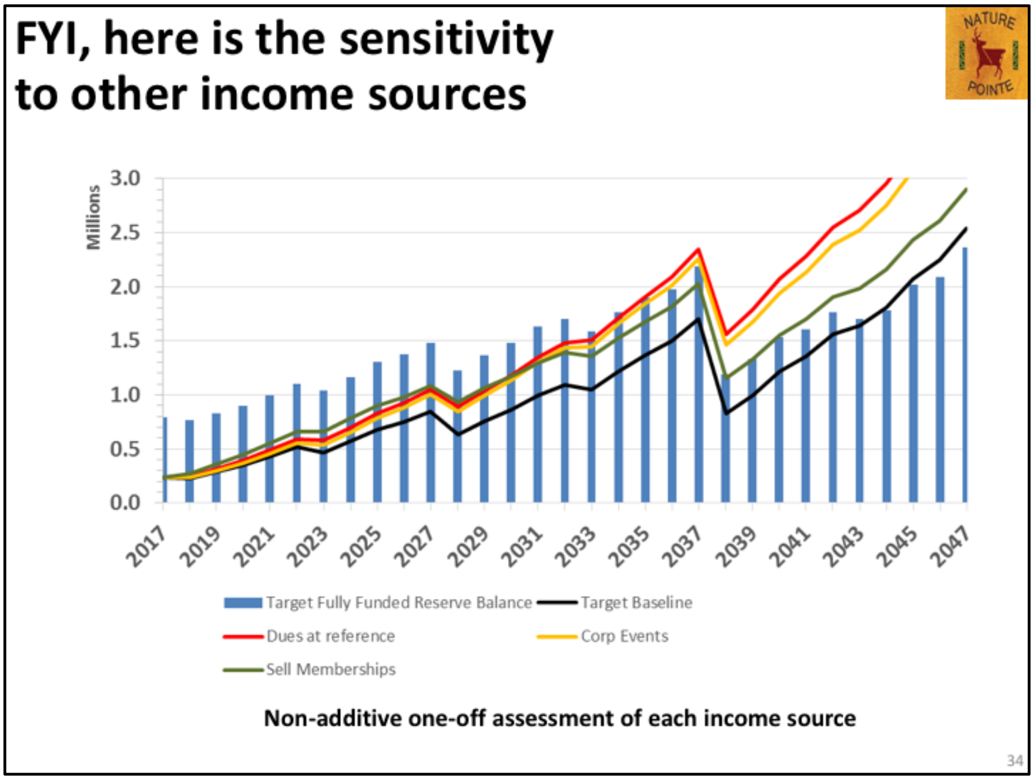


Cost inflation happens, it is not a choice. That's the way we model it

It should be an expectation that ALL sources of income will be inflation adjusted:
weddings, dues, apartment rent, plan review fees, etc
Every year would be annoying, but maybe every 3 years (heads up for 2018)
Based on actual inflation for the previous 3 year

Income adjusted for inflation IS a choice, and the model gives you that choice
But we would be foolish not to periodically adjust dues for inflation



Dues at reference: 160/90 to 200/100

Sell corporate events: weddings will decrease by for every 3 lots sold. Back fill with corporate events limited by SUP limit of 12

Sell memberships: $150/mo/membership, number = 112- number of homes, not much thought given to business model for this and applicable codes and laws

Future goal: Move away from average inputs and consider full spectrum of possible inputs ……………

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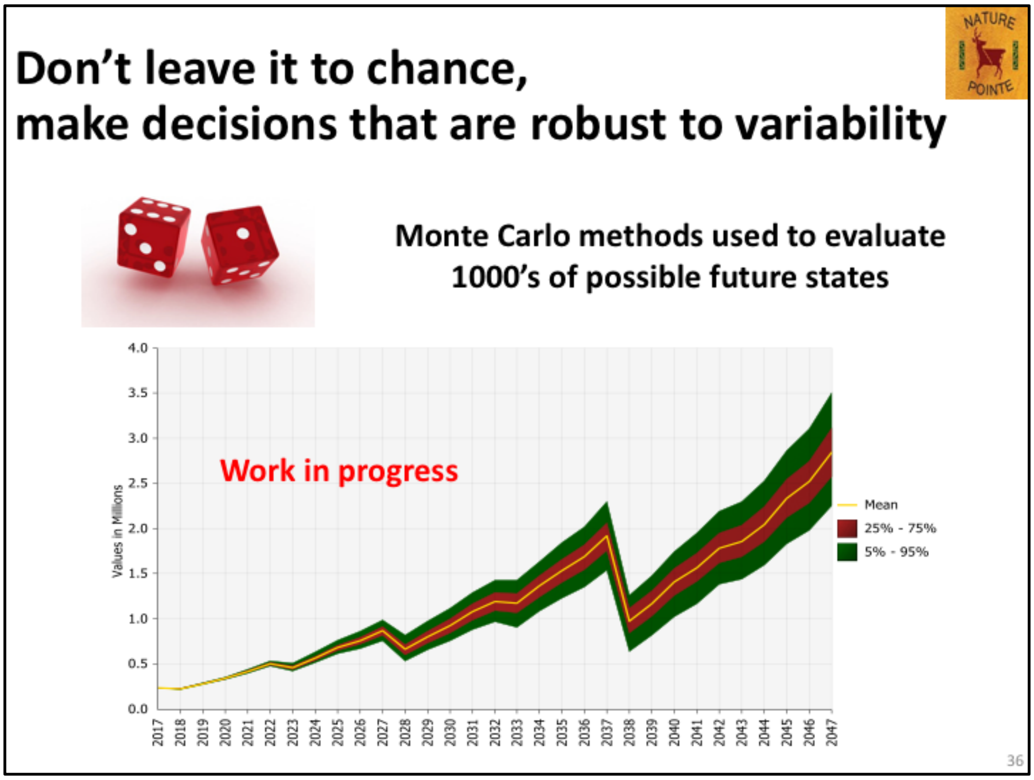
Current model: we use average or representative values for over 100 inputs

But all those inputs could reasonable take on my possible values , and some combinations could lead to disaster (i.e., SA's)

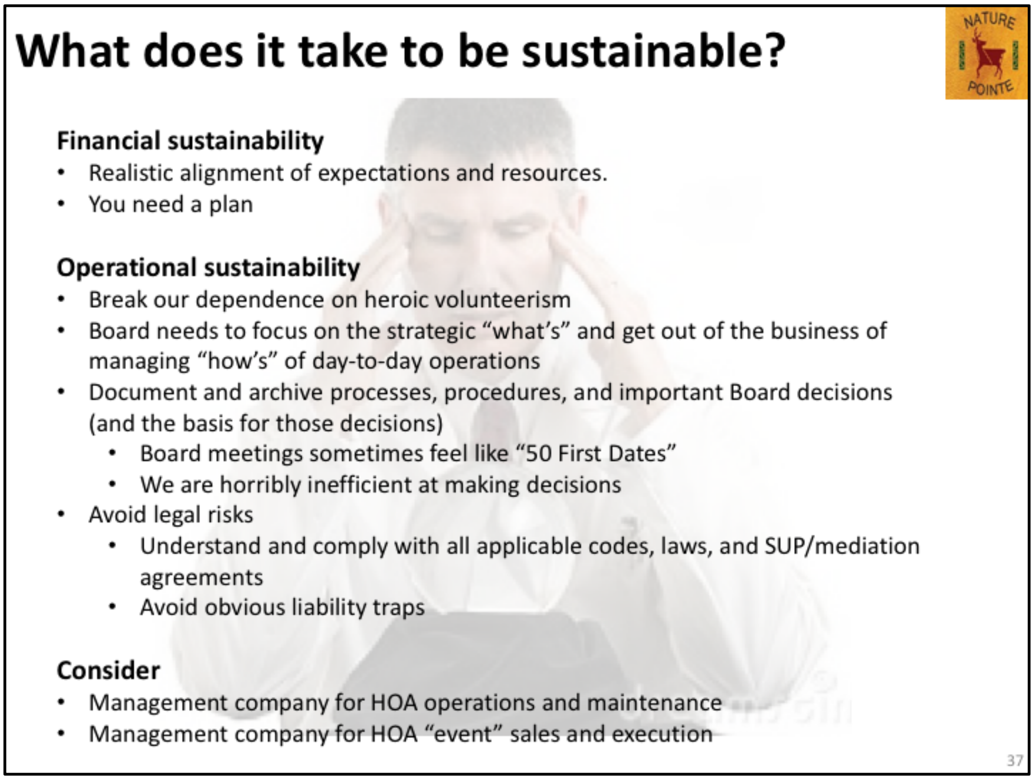


There are hundreds of inputs to the model, and they are all uncertain i.e., growth assumptions, inflation, costs, useful lives, etc
What if you wanted to explore the impact of all that uncertainty on model predictions
You could vary each of the uncertain inputs one at a time, but its highly unlikely that only one uncertain input will deviate from its baseline
or you could vary two or more simultaneously if you wanted to, and keep a record of the results
Very very very tedious, and not very rigorous

We have coupled the NP Business model with software called @Risk
The software allows us to easily vary all of the uncertain inputs simultaneously and run thousands of scenarios with different combinations of uncertain input
The software summarizes all the results and presents them in useful plots (see graphic on the slide, this is an actual calculation ofr NP with only a limited number of uncertain inputs)

It could be that some combinations of uncertain inputs will lead to special assessments. The software will keep track of how often and how much those special assessments are
This gives us the ability to answer the question that AR *can not answer* (or anyone else for that matter)
Specific to Nature Pointe: given the reserve fund strength today, and a management

plan going forward, what is the risk (and magnitude) of special assessments in the future?
If the risk is too high, change the management plan!



Unfortunately, a move towards operational sustainability will likely but an added burden on financial sustainability

50 First Dates is a movie where the star, Drew Barrymore, wakes up every morning with no recollection of the day before and her boyfriend has to win her affections all over again

Understand and comply with all applicable codes and laws and SUP/mediation agreements (Chandelier brought up to code, recent fire marshal inspection addressed)
   We are running a business now, and we can be shut down for non-compliance

Liability traps (we've been slowly eliminating traps: contractors vs employees, liability for community volunteers, etc). Still have issues
   Playground is not code, and has had safety issues in the past
   Attractive nuisances on NP property
   Open gate(s) invite security problems
   Developer does not have insurance

If you don’t do something, you will end up where you are headed -Lao Tzu-

“A good plan violently executed now is better than a perfect plan executed at some indefinite time in the future”
-General George S. Patton Jr.-

Nature Pointe Business Model
- **Use it now to make better informed decisions!**
- **Be transparent with the community**
- **Make it better as we go**

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Desperately in need of heroic volunteers

- **Verify calculations in the model**
- **Research new options to reduce costs**
- **Research new options to generate added revenue**
- **Creative thinkers to identify alternate paths to a sustainable future with less or no weddings**
- **Research HOA management companies**
  - Operations and maintenance
- **Research options to contract wedding sales and staffing**

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