Waterlefe Community Development District

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Prepared by:

Steve Sanborn - Chairperson

Tony Tierno

Tony Maddaloni

Ron Myers

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Problem Statement

The Waterlefe Community Development District (CDD) is responsible for managing many of Waterlefe's public assets, including the Waterlefe Golf Course. The CDD Board's primary responsibility is to sustain community assets in order to maintain and if possible improve Waterlefe property values.

Currently, the CDD is in default on the Revenue Bonds that were issued to purchase the Waterlefe Golf Course. Monies are also allegedly due WCI (the developer of Waterlefe) for services performed for the CDD as noted in the Waterlefe Trust Indenture Agreement, the Waterlefe Golf Course Purchase Agreement, the Waterlefe Golf Course Management Agreement and the CDD/WCI Deficiency Agreement. The defaulted Revenue Bonds and the unresolved WCI debt are currently adversely impacting Waterlefe's home sales and are perceived to be impacting Waterlefe property values.

The Bond Investigating Committee will examine the facts surrounding the delinquent Waterlefe Revenue Bonds and the alleged WCI debt and will make a recommendation to the CDD Board on approaches that could be followed to resolve both issues.

Facts and History

A) Initial Phase: Revenue Bonds Issued & WCI Guarantees Bond Payments (2001 to 2007)

The CDD (an independent special district established pursuant to Chapter 190, Florida Statutes) purchased the Waterlefe Golf Course from WCI on March 21, 2001, for $10.580 million. Prior to this transaction the CDD issued Revenue Bonds, via their Trust Indenture Agreement, totaling $9.5 million to finance part of this purchase. At the closing, the CDD transferred $7.215 million to WCI to cover the majority of the purchase price of the golf course. An additional $1 million was placed in a reserve account for the subsequent payment to WCI for the construction of the Waterlefe Pro Shop building. The balance of the purchase price or $2.365 million was paid with a subordinated note from the CDD. This note was subordinate to the Revenue Bonds and could be paid if there were net revenue remaining from the operation of the golf course after debt services were paid on the Revenue Bonds. The remaining proceeds from issuing the Revenue Bonds or $1.285 million were deposited in various reserve accounts as required by Article III of the Trust Indenture Agreement. **At the time of this transaction, the CDD Board only included WCI employees.**

The CDD/WCI Deficiency Agreement required WCI to guarantee the payment of principal and interest on the Revenue Bonds.

The Golf Course Purchase Agreement required WCI to provide the CDD with a line of credit to cover operating expenses to the extent that gross revenues from golf course operations were insufficient. That agreement also provided WCI with an option to purchase the golf course from the CDD under certain conditions.

On March 21, 2001, WCI also signed a Management Agreement with the CDD to manage the Waterlefe Golf Course. That agreement provided WCI with an annual management fee of $150,000. During WCI's management, the golf course never made an operating profit (net income excluding depreciation and interest expense). Annual operating losses exceeded $250,000, and in some years approached $500,000.

B) Second Phase: WCI's bankruptcy (2008 to 2013)

WCI filed for bankruptcy in August, 2008, at which time the guaranteed payments required in the Deficiency Agreement were discontinued and the Golf Course Management Agreement was terminated. Payments continued to the bondholders from a reserve fund, required in the Trust Indenture Agreement, until October, 2009. Subsequent to that time, the golf course was managed by Escalante Golf and Rizzetta Management. During this period net operating profits varied between a loss of $43,357 and a profit of $46,330; averaging a profit of $8,687 per year.

Payments to the bondholders were suspended in 2010. The bondholders received interest and principal payments totaling $7.4 million from 2001 through 2009.

Under the Trust Indenture Agreement the bondholder's only remedy in default is the ability to take control of the flow of funds through the various golf course financial accounts. The bondholders could redirect revenue flow in such a way that some or all of the funds bypass the golf course operating account and go to the principal and/or interest payment accounts. If the bondholders required all of the funds to bypass the operating account, the golf course would be unable to meet its normal operating obligations, and would have to close.

The bondholders do not have any rights to the property on which the golf course is located, nor do they have the right to take control and manage the course. They do not have the contractual ability to change the management of the course, but could request the appointment of a receiver where they would have to show that the course is being mismanaged. To date, the bondholders have not elected to change the flow of funds or attempted to take control of the management of the golf course. Additionally, the CDD is not obligated to liquidate any of its assets to compensate the bondholders, nor do they have any obligation to redeem the Revenue Bonds.

C) Present Phase: Current Activities (2014 to Present)

In December, 2014, a majority of the bondholders, through the trustee's attorney, approached the CDD and requested a proposal that would resolve the defaulted golf course Revenue Bonds. The bondholder's trustee attorney arranged to have a consultant review the golf course operations in late 2014. A report was subsequently issued that suggested some operating changes. None of the consultant's suggestions made a material change in the financial results of the golf course. (Reference the Hampton Golf Report & Golf Committee Response Report)

A rate study was also completed in 2015 by another consultant. This study was required by the Trust Indenture Agreement. Again, none of the comments in this report had a material impact on operations or the operating profit of the golf course. (Reference the Waterlefe Golf Club Consultant Report by Rich Hohman dated August 17, 2015 and Golf Committee Response Report)

An individual claiming to represent a real estate company purchased an option to buy the Revenue Bonds and contacted the CDD proposing to solve the Revenue Bond default. This option expired on 12/31/2015 and no action was taken by the CDD Board.

D) <u>Significant Bond Debt Issues</u>

The current principal amount due on the Revenue Bond debt is $8.37 million. The current CDD financial statements also reflects an amount in excess of $11.29 million as monies due WCI. As noted, this liability was created from the Golf Course Purchase Agreement, WCI's guarantee payments to the bondholders, golf course management fees and monies provided by WCI to fund golf course operating deficits while WCI managed the golf course. Unpaid interest due on these obligations is in excess of $5 million.

The Revenue Bonds are secured by the gross revenue from golf course operations. The security related to the WCI debt are the net revenues generated by the golf course. The WCI debt is subordinate to the Revenue Bonds. However, if the Revenue Bond debt is resolved without addressing the WCI debt, the WCI debt could take a primary position. We have been informed by our bond counsel that the CDD may have certain defenses to the collection of a significant amount of the WCI debt.

Suggested Alternative Plans

The recent activities undertaken by the Revenue Bond trustee's attorney, the efforts made by the noted real estate company to purchase the Revenue Bonds, and the decline in home sales in the community have prompted the CDD Board to address these delinquency issues.

There appear to be three general actions that the CDD can consider when the delinquency issues are addressed:

1. The CDD could choose to close the golf course. (Pursuant to the Trust Indenture Agreement, the CDD is contractually required to operate and maintain the golf course in an efficient and economical manner and shall at all times maintain the same in good repair and sound operating condition. However, the CDD can choose to close the golf course if agreed to by the bondholders and WCI, or they could be forced to close the golf course if the bondholders were to change the flow of funds bypassing the golf course operating account.)
2. It can continue to maintain control of the golf course, or
3. It can give up control of the golf course.

The CDD Board is faced with choosing one of these actions unless another action is brought forward. Action (1) will be addressed in our Summary and Recommendation section. However, actions (2) and (3) can generate a number of scenarios or "alternatives" that need to be understood and considered before a final plan is developed. In other words, once either action (2) or (3) is chosen, a plan to implement that action must be developed. We are calling these plans "alternatives".

The following represents an outline of four "alternatives" that could be considered to resolve actions (2) and (3) above. Other "alternatives" were considered in developing this report, however, the following are considered the most logical. In the Summary & Recommendation section we have identified each of these "alternatives" and outlined the consequences for action (1).

A) CDD Maintains the Status Quo (By Attempting to Pay Bond Debt from Golf Operations)

WCI's bankruptcy action in 2009 removed its guarantee of the debt service payments for the golf course Revenue Bonds. Since that time, a major CDD objective has been to maximize golf course operating profits in order to maintain and protect the Waterlefe golf course and make the required Revenue Bond debt service payments. Since 2009, the CDD has continuously improved golf course operations in an attempt to improve profitability. Despite these efforts the golf course has been unable to generate the operating profits and cash flow needed to meet its debt service requirements. The unresolved Revenue Bond delinquency and the WCI debt has caused uncertainty regarding real estate sales within the community.

Based upon the limited security available to the bondholders and WCI, the CDD Board could continue to operate the golf course. However, the golf course has not generated sufficient operating profit and cash flow to service the debt issues, and is unlikely to do so in the future.

Summary:

Pros:

To date, golf course assets have been operated and maintained with limited profitability. (It should be noted that the CDD has provided limited funds to pay for expenditures in order to maintain critical golf course assets and systems.)

Cons:

Insufficient golf course profits and cash flow will cause the Revenue Bonds to remain in default.

Uncertainty regarding resolution of the noted defaults could impact home sales further.

Public perception of the community could be impacted.

Bondholders could cause the golf course to close by changing the flow of gross revenues in an attempt to satisfy principal and interest debt requirements, bypassing the golf course operating account. The CDD might have to use general assessment revenues to maintain the course so it does not go fallow, thus reducing home values.

WCI debt remains unresolved.

B) CDD Sells the Golf Course

If the CDD decides to sell the golf course it must do so at a price that would allow it to pay off the amounts due the holders of the Revenue Bonds and WCI. Accepting a sales price below that amount would require the consent of the bondholders and WCI.

No attempt was made to obtain an appraisal for the sale value of the Waterlefe Golf Course. It is believed that the benefit of this exercise does not warrant the related cost at this time. Based upon our contact with golf industry consultants and other available information, we have learned that the industry is in a depressed condition. Currently, hundreds of golf courses are closing annually and very few are being built. Comparing this information to conditions in our geographic area we have seen that the most successful golf courses built within a community similar to Waterlefe have been structured in a "bundled" environment. "Bundling" requires all residential property owners in that community to join the golf course. Those semiprivate golf course that are not "bundled", like Waterlefe, struggle financially and attempt to attract public players to meet their budget needs. In our opinion, this environment would not attract a sufficient selling price for the Waterlefe Golf Course that would cover the Revenue Bond and WCI debt obligations.

Considering a sale, there are at least three potential types of golf course buyers. The first would be a golf course management company whose primary business is owning and operating golf courses. The second possibility is a real estate company whose primary business is selling homes. Finally, some Waterlefe residents might be a buyer.

A successful golf course management company might be an acceptable option. However, there are no guarantees that any golf course management company could successfully operate the Waterlefe Golf Course. A golf management company would expect to achieve sufficient profits to make a reasonable return on their investment.

Owned by the CDD, the Waterlefe Golf Course has some significant advantages compared to ownership by a golf course management company. As a government agency, the CDD is not required to pay sales tax which give the CDD a 6.5% advantage with respect to purchasing operating expenses and capital assets. In addition, CDD ownership eliminated the payment of real estate taxes on golf course real estate. Also, the golf course has been assigned twelve (12) assessable units to which the CDD can bill operating and maintenance fees (non-ad valorem assessments). These fees have been waived by the CDD Board for the golf course due to the redundant aspect of the CDD billing itself for these fees. However, this fee would probably be reinstated if the golf course is sold to a third party.

The Waterlefe Golf Course has saved in excess of $150,000 annually in operating expenses because the CDD is a government agency and the waived CDD operating & maintenance charges. A management company would be required to pay these taxes, reducing its profitability and possibly limiting its ability to maintain the quality of the golf course.

Despite the benefits of CDD ownership, the Waterlefe Golf Course has only managed a very small operating profit since the WCI bankruptcy. Therefore, it is unlikely that a management company would pay a significant purchase price to own the Waterlefe Golf Course. If sold, a major reduction in golf course operating expenses would be needed to generate a reasonable return on investment and could result in a significant reduction in the quality of the golf course. This could ultimately impact residential property values.

If a golf course management company did not meet its profit requirements while owning the Waterlefe Golf Course, it might sell the course to a real estate developer. While this may seem unlikely, this is happening at Gulf Gate in Sarasota. Instead of residents looking at an attractive golf course, condominiums could be built on the golf course property, reducing property values. There are safeguards in effect to assist in preventing this at Waterlefe, but this eventuality cannot be simply ignored.

One of the primary CDD responsibilities is to sustain its assets and thus protect the value of residential properties. If the CDD were to sell the golf course to a third party its ability to protect property values within Waterlefe will be diminished.

While it may seem attractive to sell the course to Waterlefe residents, in the long term this would not be any different than selling to any other buyer. Eventually, the ownership would pass either through inheritance or sale to other individuals, and issues similar to those noted above could occur.

Summary:

<u>Pros:</u>

Proceeds of a sale would reduce or eliminate the Revenue Bonds and the WCI debt.

Selling the course would reduce CDD management and administrative costs.

<u>Cons:</u>

The community loses control of the golf course, risking lower home values.

Golf course property could potentially be converted to condos, risking lower home values.

Third party ownership could have a direct impact on the quality of the golf course leading to lower home values.

Third party ownership could limit or eliminate the access by non-golfing residents to use facilities like the Grille Room for non-golfing events (playing cards or meetings).

C) <u>Residents Buy the Revenue Bonds</u>

A group of residents might attempt to purchase all of the outstanding Revenue Bonds. The residents could be ideal bondholders because they would want to maintain the quality of the golf course in order to protect both the golf course and their property values. However, there are a number of issues that must be addressed to achieve this objective. Developing a consortium of potential buyers into an organized group would be extremely difficult. Funding the actual purchase event might prove to be difficult due to the significant pre-purchase administration, legal and cost complexities. As residents mature or circumstances change, resident owners may need to sell their Revenue Bonds. This could lead to non-residents owning the Revenue Bonds creating the same environment we are facing today. Residential ownership might create operating difficulties with the management of the golf course by interfering in operational management issues. Finally, while the WCI debt issue would not require a payment in this scenario, it will ultimately require a solution.

Summary:

<u>Pros:</u>

Residents purchasing the Revenue Bonds could reduce the CDD's cost of servicing the bonds.

CDD maintains control of the golf course as long as the residents own the Revenue Bonds.

<u>Cons:</u>

The sale of the Revenue Bonds by resident bondholders to a third party might prove detrimental to the community.

Resident bondholders' possible interference in golf course operations could create problems.

WCI debt remains unresolved therefore home sales could continue to remain depressed.

The negotiations to develop this scenario and the related agreements would be complex.

D) CDD Renegotiates, Replaces or Exchanges the Revenue Bonds

The CDD Board has several courses of action with respect to negotiating with the existing bondholders. It is not possible to recommend one course of action over another with the amount of information available at this time. The negotiations will undoubtedly lead in one direction or another (i.e. renegotiates, replaces or exchanges the Revenue Bonds). A general description of one alternative follows, and the other alternatives would have similar consequences.

The CDD could offer the bondholders new bonds issued by the CDD in exchange for the Revenue Bonds. The new bonds would be payable from a special assessment levied on all of the homes within the CDD community. The exchange would be at a deep discount since the golf course revenues, which are the current security for the Revenue Bonds, are so speculative and limited.

We believe that the ultimate exchange value to settle these issues will be significantly less than the total value of the unpaid debt that currently appears on the golf course balance sheet. We also believe that the cost of the new debt will be significantly less than the possible loss of property values that would result should the CDD lose control of the golf course and that loss of control could lead to the golf course becoming an eyesore or closing.

This approach would allow the CDD to continue its ownership and control of the Waterlefe Golf Course, which is important since the golf course in its present form generates a positive impact on the value of all community properties. Based on information from similar communities, the golf course adds between 20% and 30% to the value of homes in Waterlefe.

Regardless of whether the CDD ultimately renegotiates the existing Revenue Bonds, replaces the existing bonds with new bonds or executing an exchange of bonds with the existing bondholders, the CDD will have to find a way to pay or fund a workout with the bondholders and WCI.

Summary:

<u>Pros:</u>

The golf course would continue to be managed by the CDD which will allow it to focus on maintaining the golf course which in turn should benefit all residents of the community by maintaining home values.

Restructuring of the existing debt with favorable conditions for the community would positively impact real estate sales and home values.

Exchanging the Revenue Bonds with new bonds and eliminating the WCI debt could improve the CDD's debt rating and reduce the cost of future bond issues.

Cons:

The CDD Board will need to investigate the possibility of a new assessment and/or a reduction of costs in the CDD's operating and maintenance budget in order to pay for a new bonds or loan.

Any increase in CDD fees could have a negative impact on future home values. This would be minimal compared to the severe decrease in home values if the golf course were to close, or the Revenue Bonds remain unresolved.

Trying to locate a significant majority of the existing bondholders could be difficult.

Summary and Recommendation

As previously noted, the primary objective of the Bond Investigation Committee was to review the CDD's Revenue Bond delinquency and alleged WCI debt issues, and make a recommendation on how to proceed. This report has outlined the reasonable alternatives (items (A) through (D) above) available to the CDD Board along with the pros and cons of each. The committee suggest that the CDD Board first choose one of the following three actions in conjunction with one of the above noted alternatives in order to resolve this significant issue:

1. Close the golf course, (with Bondholder and WCI approval, or as a result of maintaining the status quo).
2. Maintain control of the golf course (possible supporting alternatives – (A), (C) & (D).
3. Give up control of the golf course (only supporting alternative – (B)).

The action with the least benefit to our community would be to close the course (1) and let the property go fallow. There are many examples of this happening at other communities with the result that property values declined significantly. This would be a catastrophic result for all Waterlefe homeowners. If the community maintains control of the golf course, and the course has to be closed, at least the land could be maintained, and perhaps used for other recreational purposes. If the course were to be sold (give up control), and then closed, the community would have no ability to maintain the property, and it could go fallow or possibly converted to condominiums.

Assuming the golf course could be sold for sufficient funds to pay off the Revenue Bonds and pay the WCI debt, the committee believes that giving up control of the golf course (action #3) by means of a sale would be a risky alternative. There could be only one positive outcome for such a plan, and several negative outcomes. On the positive side, a golf course management company could be successful. However, as noted above, there are several disadvantages to third party ownership when compared to the CDD owning and operating the golf course. In general, the new owners would expect to make a reasonable profit on their investment whereas the CDD has some advantages not available to a private or public company. Additionally, giving up control of the golf course, the community's largest and most visible asset, significantly reduces the CDD's ability to maintain community property values

Considering the information noted in this report, specifically alternatives A, C & D, the committee suggests the following:

1) The best action for the CDD is to **maintain control of the golf course (action #2), if it can be achieved at a favorable cost** and address the delinquencies as opposed to maintaining the status quo. When evaluating a favorable cost, the overall community impact on property values resulting from closing the golf course should be considered. This can be accomplished by using lost property values experienced at other communities that have shuttered golf courses. Any potential solution should be compared against the possible overall loss of community property values.

2) If it is decided to resolve the bond delinquency and the WCI debt by incurring new debt (new bonds or a loan), the related payments should be spread over as many years as possible in order to minimize the impact on the CDD's annual budget and individual property owners' assessable fees. The CDD will also need to develop a methodology for the allocation of any special assessment to the various types of assessable community real estate.

3) The CDD should maintain primary responsibility for the course, and to the extent possible, the golf course should be required to participate directly in the payment of any fees incurred to resolve the Revenue Bond debt and any WCI payments.

4) The CDD should consider the potential of eliminating or reducing CDD operating and maintenance costs to help offset the impact of any new fees related to the resolution of the Revenue Bond debt and any WCI payments.

5) The committee does not feel it has enough information to make a recommendation on the specific alternative ((A), (C) or (D)) of maintaining control. Choosing a specific alternative is dependent upon negotiations with both the bondholders and WCI. However, whatever alternative is chosen must include the resolution of the Revenue Bond delinquency and the alleged WCI debt.

References

Trust Indenture Between Waterlefe Community Development District and First Union National Bank, Miami, Florida, as Trustee, Dated January 1, 2001.

Golf Course Purchase Agreement Between Bay Colony-Gateway, Inc., and Waterlefe Community Development District, Dated March 21, 2001.

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