EXPERTS' CORNER

Q **How should a club structure financing of capital expenditures so that the long-term financial health is not threatened?**

A Clubs strive to have their operations at least break even each year, before depreciation, thus eliminating the necessity of end of year assessments to cover operating deficits. Club management must consider how the club's capital needs essential to the long-term health of the club are to be financed. The financing of capital projects can, depending on the structure, impact, and possibly deliver a blow to, a club's finances that could last for decades.

In most clubs, ongoing capital expenditures are funded by a base layer of ongoing capital assessments. They're also supplemented by initiation fees, which may fluctuate based on membership levels, turnover, the economy and other factors. These two sources of dedicated revenue should be sufficient to fund ongoing capital expenditures absent a large capital project. In a recent survey of 250 private clubs, 84 percent of golf and country clubs, 83 percent of tennis, beach and yacht clubs and 33 percent of city clubs had some form of capital assessment.

Large Capital Projects

Generally, large capital projects require funding above the levels provided by ongoing capital assessments and initiation fees. In certain cases, it may entail a much larger capital assessment, outside financing (bank loan), or member financing in the form of a membership bond, a certificate of indebtedness or membership certificate, or a combination thereof. The singular, large assessment route is usually not chosen, as it typically doesn't receive the approval of the membership. Obtaining bank financing, coupled with an increase in an existing capital assessment for the term of the loan to pay debt service, has proven to be a popular alternative. Another alternative is to issue or increase the value of a bond, certificate of indebtedness or membership certificate equal to the payment being made.

Typically, members will the get the increased value of the certificate back when they leave the club, provided there is an incoming member to replace them, and the new member pays for the certificate. In effect, the members are providing interest-free financing to the club during their membership and since they receive their money back, they effectively never pay for the project, although they get the benefit of using the facility while a member.

The issuance of certificates is another device to raise funds. Approximately 51 percent of the golf and country clubs and 33 percent of tennis, beach and yacht clubs surveyed issue some form of stock, bond or certificate. Although popular with members, such a financing mechanism is generally not in the long-term best interest of the club. In the short term it works—but in the long term the financial effect on a club's cash flow can be drastic.

For example, Club A has 250 certificate-holding members. Over time, capital assessments for projects have added to the value of the certificate. The certificate, originally issued with a value of $1,000, is now valued at $10,000. The club's total certificate value outstanding is $2,500,000 (250 x $10,000).

If the initiation fee is also $10,000, a new member pays $20,000 ($10,000 for initiation fee and $10,000 for a certificate) of which the club only gets $10,000, because the other $10,000 for the certificate goes to repay the outgoing member. If the membership turns over every 25 years, then over the next 100 years the club loses $10,000,000 (4 x $2,500,000) of available cash flow due to this financial structure. One-third of the country clubs that issue certificates value them at $10,000 or more.

In another example, if Club B has 300 certificate-holding members and the certificate is valued at $20,000, the total value is $6,000,000 and the future negative cash flow impact will be $24,000,000 (4 x $6,000,000).

The more certificate-holding members a club has, and the larger the value of each certificate, the more potential detrimental effect it will have on the club's future cash flow.

The Solution

There is a solution for clubs that have issued bonds or certificates that have increased in value over the years due to assessments being added to their value. Clubs should consider lowering the amount of a new member's payment that is designated for a bond or certificate with a corresponding increase in the initiation fee. Using Club A as an example, the new member would still pay $20,000; however, only $1,000 (or possibly a nominal amount) would be allocated to a bond or certificate purchase while the other $19,000 would be an initiation fee. Initially, the club will not benefit from the change, since they will have to redeem the outgoing member's certificate; However, as new members ultimately leave the club, the cash flow from initiation fees will improve, especially over time. For clubs that have bonds or certificates outstanding, it is a long-term solution to a potential multi-million dollar cash flow issue without increasing costs to existing members.

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