

Date: December 15, 2006

Subject: **FY2006 Financial Review & FY2007 Budget Recommendation**

The purpose of this letter is two-fold:

1. To summarize VDM's current financial position compared to the FY 2006 budget (based on 10 months of "actuals" up to October 31<sup>st</sup>, plus estimates for November and December) and,
2. To present to you the VDM FY2007 Budget recommendation which was approved by the Board of Directors during its regular meeting on December 9<sup>th</sup>, 2006 for submission to owners.

Attached to this letter is a rather detailed spreadsheet which summarizes FY 2006 performance, the recommended FY 2007 budget, and comparable figures for two previous years – 2004 and 2005. For those of you whose eyes literally "glaze over" when looking at all these numbers, I will attempt to clearly point out and explain in this letter the reasons for any major differences between the new budget and 2006. Hopefully this will help address some of the more obvious questions you may have.

### **Overview:**

First, what you are about to read contains both "good" and "not so good" news with respect to VDM's financial status and outlook. Let me start with the "not so good" news (or "bad" news depending upon your perspective as an owner, as I am). The primary recommendation in this FY2007 budget is that a +15% increase in maintenance dues will be necessary, effective the 1<sup>st</sup> Qtr, 2007. I (and the majority of the Board) strongly believe that, while none of us want a dues increase, this increase is absolutely essential to strengthen VDM's current financial condition and to assure that our cash reserves (which have been drawn down during 2006 due to our extraordinary legal and tax expenses) will be restored in order to sustain Vida's longer term financial health. I explain the reasons for this in more detail below.

The "good" news is that during the past year we have continued to institute new improvements in our accounting and cash management procedures, and in our financial reporting to you, the owner. These improvements have built upon those made by the last year's Board. Our major objectives in implementing these improvements have been full transparency, accuracy and stronger budgetary control. We have now completely converted to a true "accrual based" accounting system (which matches revenues and expenses with when they are incurred, rather than when they are paid). And, as you know, our Controller, Ulises Huerta, now publishes a monthly Financial Report on the VDM website (consisting of an Operating Income Statement, a Cash Flow Statement, and a Balance Sheet – the three essential ingredients to any good financial reporting system).

It is this financial tracking system which has been the foundation for preparation of the 2007 budget. Development of the FY 2007 budget actually began with a complete 6 month review of 2006 back in July (which compared year-to-date actuals vs. budget and then prepared a revised projection of what the balance of 2006 would look like). As a result, the 2007 budget being recommended represents effort over the past year by our Controller, the General Manager, your Treasurer and the Board to further refine our understanding of how and where Vida's funds have been and are being spent, and then to determine what needs to be budgeted next year, keeping in mind the need to balance what is "desired" with what is really "required" to keep the level of service and appearance of the VDM's buildings and grounds at the high levels expected by all owners.

### **Review of FY 2006 Performance vs. Budget**

On an overall basis, it is currently projected that the total 2006 "bottom-line" deficit (including operations and extraordinary income and expenditures) will be (\$467,942) pesos. Note that this is "only" \$169,738 pesos more than the FY 2006 budgeted deficit of (\$298,203), which was approved last January, 2006.

I say “only” because, as shown below in the table below summarizing “over and under” variations for 2006, actual unbudgeted legal expenses (both operating and extraordinary) significantly exceeded the original 2006 budget largely due to 1) an unexpected tax payment to Hacienda, the Mexican IRS; 2) an owner mandate last January to restructure the legal organization of VDM in its entirety during 2006; 3) the need to prepare a new Operator Contract for L’Recif; and 4) unbudgeted legal expenses associated with the Union contract. The “good” news is that we were able to “cover” most of this unexpected overage because: 1) we collected a significant amount of unbudgeted owner dues delinquencies during the year (\$354,934 pesos) and 2) management was able to efficiently manage spending on many other “controllable” expenses throughout the year.

**VARIANCE COMPARISON (+/-) between FY 2006 Expected Actuals and FY 2006 Budget**

|  |                    |                      |
|--|--------------------|----------------------|
| <b>Total Operating Revenues (i.e. dues, interest and currency variations):</b> | <b>\$235,064</b>   | <b>(Over Budget)</b> |
| <b>Less:</b>   |                    |                      |
| Total Labor and Admin. Payroll Expenses:                                       | 43,582             | (Below Budget)       |
| Total Operating Legal Expenses (L’Recif contract and Union contract):          | (114,391)          | (Over Budget)        |
| Total Maintenance Expenses:  | 24,266             | (Below Budget)       |
| Total Utilities Expenses (Electricity, Water & Gas):                           | (47,781)           | (Over Budget)        |
| Recovered Expenses (payments to VDM from owners & L’Recif ):                   | (182,310)          | (Below Budget)       |
| All other operating expenses:  | 35,624             | (Below Budget)       |
| <b>Total Variance in Operating Deficit:</b>                                    | <b>( 5,946)</b>    | <b>(Over Budget)</b> |
| Collection of Past Due Maintenance Fees:                                       | 354,934            | (Over Budget)        |
| Less Extraordinary Legal/Restructuring & misc. '05 Carryover Expenses:         | (518,726)          | (Over budget)        |
| <b>BOTTOM LINE - Total Overall Variance (Act. Deficit vs. Budget Deficit):</b> | <b>(\$169,738)</b> | <b>(Over Budget)</b> |

You’ll note on the attached spreadsheet that we have also “reconstructed” prior year actuals (2004 and 2005) from past records so that you can make some comparisons on a prior year-to-year basis.

**FY 2007 Budget Strategic Objectives:**

In preparing the 2007 budget, we took a very pragmatic approach to what it would take to accomplish the Board’s key strategic budget objectives, as outlined below.

**1. Develop a 2007 Operating Budget which is BALANCED or as close to balanced as possible.**

As you can see on the attached spreadsheet, Vida has generated bottom-line total deficits for each of the past three years (2004, 2005 and 2006). In fact, even with the 5% dues increase voted on by the ownership last January, the approved 2006 operating budget proposed a negative (\$538,275) “operating deficit” (i.e. before extraordinary revenues and expenditures). This “balanced” budget objective therefore clearly recognizes that **VDM simply cannot continue to generate sizeable negative operating budget deficits because of their corresponding negative impact on cash balances and reserves.** It was the Board’s view in approving this budget recommendation that we have to act now, “bite the bullet”, and make every attempt to meet this objective next year.

**2. Reduce expenses where we can do so without sacrificing quality and operating efficiency (i.e. in areas like personal service, the upkeep and appearance of buildings and grounds, essential maintenance, etc.)**

**3. Rebuild VDM’s cash balances and reserves throughout 2007.**

Due to the actual operating deficit projected for 2006 (estimated to be \$544,222 by year-end, only \$5,946 pesos larger than the budgeted deficit) and the large unbudgeted extraordinary cash outlays in 2006 (primarily for the legal restructuring and the Hacienda tax payment of nearly \$200,000 pesos in June), VDM’s cash reserves by the end of December are projected to be approximately ½ of the required 3 months reserve level. While we are not in immediate danger of running out of cash and the law says that we have a “reasonable amount of time” to restore the cash reserve, it is clear that we must act now to do so.

**Proposed FY 2007 Budget - Summary**

The “quick summary” table below illustrates where the major (+/-) variations between the 2007 budget and 2006 occur and why they occur. All of these numbers are derived from the attached spreadsheet. Each line item in the table is notated and the reasons for the variances explained below it.

| Item | VARIANCE COMPARISON (+/-)<br>Recommended FY 2007 Budget vs. FY 2006 Actuals     | Budget<br>+/- vs. 2006 |
|------|---|------------------------|
| 1    | <b>Operating Revenues:</b>  |                        |
|      | Increase in Revenues from 15% increase in Owner Dues:                           | \$1,071,225            |
|      | Decrease in Revenues – penalties, interest earned & exchange rate fluctuations: | (114,289)              |
|      | Net Increase in Total Revenues:   | \$956,936              |
| 2    | <b>Operating Expenses:</b>  |                        |
| 3    | Increase in Labor and Admin. Total Gross Payroll Expense:                       | (79,024)               |
| 3    | Increase in Payroll Benefits Expense:   | (300,531)              |
| 3    | Increase in Social Security & Other Payroll Taxes:                              | (199,503)              |
| 4    | Decrease in Legal Expenses (will be primarily Union contract issues in '07):    | 153,392                |
| 5    | Increase in Utilities Expenses (Electricity, Water & Gas):                      | (62,219)               |
| 6    | Increase in Recovered Expenses (receipts from owners & L'Recif):                | (54,310)               |
| 7    | Increase in expense due to Depreciation (a new non-cash expense category):      | (54,000)               |
|      | Decrease in all other operating expenses categories:                            | 21,730                 |
| 8    | <b>Decrease in Operating Deficit (2007 Budget vs. 2006 Actual):</b>             | <b>382,471</b>         |
| 9    | Decrease in Extraordinary Collection of Past Due Maintenance Fees:              | (537,676)              |
| 9    | Decrease in Extraordinary Legal Expenses (finishing of restructuring corp.):    | 363,726                |
| 10   | Change due to no carry-over surplus from 2006:                                  | (57,330)               |
| 11   | <b>BOTTOM LINE - Total Overall Decrease in Planned Deficit:</b>                 | <b>\$ 151,191</b>      |

***Operating Revenues*<sup>1</sup>:**

The 2007 budget proposes a 15% increase in owner dues effective on January 1, 2007, resulting in a + \$1,071,225 increase in dues revenue in 2007 vs. 2006. This will help generate total net revenues of \$8,442,725 pesos in 2007, an increase of \$956,936 pesos compared to 2006. (Note that to be conservative, we have not estimated income changes caused by currency exchange rate fluctuations. Beginning in 2007, we will show this “exchange rate” effect separately so that we can track both interest income and currency exchange fluctuations individually.)

***Operating Expenses*<sup>2</sup>:**

The 2007 budget projects total Operating Expenses at \$8,604,476 pesos, which is 7.2% higher than total 2006 actual operating expenses. This is substantially less than the increase in total actual operating expenses between 2005 and 2006, which was +18.8%. The increase from 2004 to 2005 was +1.5%.

*Total Labor/Payroll Expenses*<sup>3</sup>: The total increase in payroll expense in the 2007 budget (i.e. sum of gross pay + benefits + payroll taxes) equals \$579,058 pesos (\$79,024 + 300,531 + 199,503). As shown in the table below, this represents a +12.5% increase in total payroll vs. 2006, and is certainly in line with the total payroll expense increases experienced in both 2005 and 2006 vs. the prior year.

(Please note that for 2007 we have changed the budget format by moving all administrative personnel out of “Labor” and down into the “Administration” section of the budget, along with Sr. Management. We also moved all related administrative benefits and Social Security taxes down into this section as well.)

|                                | FY 2004 (Act.) | FY 2005 (Act.) | FY 2006 (Act.) | FY 2007 Budget |
|--------------------------------|----------------|----------------|----------------|----------------|
| <b>Total Payroll Expense:</b>  | \$3,557,102    | \$4,121,392    | \$4,621,418    | \$5,200,476    |
| <b>% Increase (yr. to yr.)</b> | Unk            | + 15.8%        | + 12.1%        | + 12.5%        |
| <b>% of Net Revenues:</b>      | Unk            | 61.1%          | 57.6%          | 61.0%          |

As you can also see in the table above, the percentage of total payroll expense as a percentage of total revenues each year is remarkably stable. The 2007 budget payroll recommendation is therefore quite consistent since its total projected payroll expenses equal 61.0% of expected 2007 revenues.

*Legal Expenses*<sup>4</sup>: Legal expenses are projected to decrease by \$153,392 pesos to \$201,000 pesos in 2007. Most of the legal work budgeted in 2007 will deal primarily with Union issues, unlike 2006 where the L'Recif contract termination and renegotiation required substantial legal input along with Union issues, real estate, etc.

*Utilities*<sup>5</sup>: Utility expenses (electricity, water and propane gas) are projected to continue to climb in 2007, accounting for an increase of \$62,219 pesos (+ 3% vs. 2006). As a comparison, these utilities increased by 19.9% in 2005 and by 23.7% in 2006. In 2006, propane alone was up 14.9% when compared to 2005. Propane gas is projected to increase by another 16.3% in 2007.

*Recovered Expenses*<sup>6</sup>: These are payments by owners and the operator of L'Recif for expenses incurred by Vida on their behalf (such as housekeeping, laundry, maintenance, etc.). These payments are expected to grow modestly in 2007 by \$54,310 pesos (+ 10.5%) vs. 2006.

*Depreciation Expense*<sup>7</sup>: This line item has not appeared in previous years because up until 2006 Vida utilized a "cash-based" accounting system, and depreciation is a non-cash expense. The \$54,000 represents a write-down in 2007 of those assets being depreciated (furniture, computers, tools and equipment, buildings, etc.) during the year. The reason it does not appear in 2006 is because the other categories under "Maintenance" had the depreciation already "netted out" in the numbers. We have added this line item for greater reporting accuracy.

**Operating Surplus/(Deficit)**<sup>8</sup>: The 2007 budget calls for an Operating Deficit of (\$161,751) pesos compared to the expected 2006 actual operating deficit of (\$544,222), which is \$382,471 (or 70.3%) less than 2006. This does not quite reach our objective of "operating breakeven" but it is close. However, if you subtract the only non-cash expense in the budget (depreciation) from the deficit (i.e. \$161,751 - 54,000 = \$107,751), the operating deficit is closer to our breakeven objective.

*Extraordinary Income & Expenses*<sup>9</sup>: Unlike the 2006 budget, and in the interest of being conservative, the 2007 budget forecasts NO extraordinary income for 2007. In 2006 however we did collect \$537,676 pesos in delinquent dues (hence the reason for the negative variance shown above). With the exception of two condo units, we have essentially cleaned up the backlog of overdue maintenance fees. However, two large delinquencies remain totaling approximately \$1,000,000 pesos. We fully expect to collect some percentage of this amount during 2007, but this has NOT been included in the budget. (Note: If we were to collect just 33% of this amount [\$330,000 pesos], the entire budget would be balanced [i.e. be at total breakeven on the bottom-line]. We think this is certainly doable, but do not know when it will occur.)

The extraordinary expenses of \$155,000 pesos budgeted for 2007 include \$65,000 pesos for legal work to wrap-up the corporate restructuring project, and \$90,000 pesos for the attorney handling the Hacienda tax case (this payment is due if and when VDM wins its tax case). This results in a reduction of \$363,726 pesos vs. the extraordinary expenses of 2006 (which are estimated to be approximately \$518,726 pesos). The 2006 estimate includes \$27,822 paid to our previous law firm (incurred in 2006); \$36,287 for carry-over expenses from 2006 for the office remodel, Board travel, equipment reimbursement, etc.; \$48,875 for the architectural survey to prepare the blueprints required for the legal description of VDM (required by law but never previously done); and the balance of \$405,742 for Cuesta Campos, the law firm currently handling our corporate restructuring project and Union issues.

*Carry-Over Surplus*<sup>10</sup>: There is obviously no carry-over surplus being budgeted in 2007, given the total deficit projected for 2006 (\$467,942).

**THE BOTTOM LINE - Total Surplus/(Deficit)**<sup>11</sup>: The 2007 budget therefore projects a total bottom-line deficit of (\$316,751) pesos, compared to a (\$467,942) deficit for 2006, which is \$151,191 pesos or 32.3% less than the 2006 projected deficit.

**Conclusion**: As you review this budget, please know that we reviewed many other options in preparing it. One obvious option would have been an austerity budget which would have demanded substantial cuts in personnel and operating expenses in order to balance the budget without any increase in dues.

Another would have been not to increase dues, but continue to project a substantial operating deficit for next year, which would only make our cash reserves worse. There were also other options which included various levels of dues increases between 0% and 15%, none of which met the “balanced budget” objective.

As you review this budget, please keep in mind that we have only had one dues increase (+5% last year) since 2003, and that during that time VDM’s operating costs have continued to increase (the Mexican CPI has increased approximately 4% annually over the past four years). In the final analysis, the Board felt that all of these other options ran counter to the majority of Vida owners who want their investment in VDM to increase and not decrease, and who therefore have an interest in maintaining Vida’s overall beauty, personal service and quality of life. Nobody like dues increases, but as a result of this thinking, we are recommending that the attached 2007 budget be approved during the January 2007 Assembly.

### **Importance of Rebuilding VDM’s Cash Reserves**

The third strategic objective which is closely tied to the budget is the necessity to rebuild VDM’s cash balances (and its legal cash reserves). Even with projected operating net cash flows over next year at very close to the breakeven level (as the 2007 budget recommends), this means that VDM will still need to build its cash “cushion” back up to safer levels. The law says that the legal cash reserve for VDM should equal three months of average operating expenses which has been consistently +/- \$2,100,000 pesos during 2006. Since we expect by the end of December to be at about half that amount, it is estimated that we will need to restore approximately \$1,100,000 pesos to our bank savings and investment accounts over the next year. We are currently working on cash flow projections for 2007 and beyond (the first time VDM has ever projected cash flows into the future), and will have a much better “handle” on the details once FY 2006 is finalized.

It is clear at this point that, to accomplish this important “cash replenishment” objective, the Board will most likely also be asking for owner approval in January, 2007 to do two things:

1. “Transfer” or “free-up” the balance of the funds remaining in the current Special Assessments/Capital Projects fund and move them over to cash reserves. All of the capital projects originally approved by the ownership back in 2005 have been completed with the exception of the “Grey Water Facility” which has been put on indefinite hold until it is needed. We will therefore “hold back” the balance of funds unspent and allocated for this project (currently \$68,296 pesos) and only transfer the remaining portion. That would mean that the balance to be transferred would equal approximately \$560,000 pesos as of the end of the 1<sup>st</sup> Qtr. billing cycle in 2007. (Note: A complete recap of the 2004/2005 Special Assessment/Capital Projects fund will be provided to the General Assembly in January.)
2. Approve a new Special Assessment (i.e. an “Assessment for Cash Reserve Replenishment”) for the balance of FY 2007, at levels similar to the current Special Assessment. The current special assessment is \$244,770 pesos quarterly, allocated evenly across all 199 condo units. If done over the 2<sup>nd</sup>, 3<sup>rd</sup>, and 4<sup>th</sup> Quarters of 2007, this would equal approximately \$734,310 pesos.

I apologize for the length of this summary. I felt it best to explain as much as possible about the “how and why” for the 15% increase in dues and the facts behind the budget recommendation. As I trust you will agree, we are at a critical juncture in assuring VDM’s future viability and financial sustainability. Please review the enclosed budget and let me know if you have any questions. I look forward to presenting this to you, the ownership, during the General Assembly in January, 2007.

Respectfully submitted,

Al Lewis  
Treasurer and Vice President  
Vida Del Mar Board of Directors