Financial Explanation of the Fourth Amendment

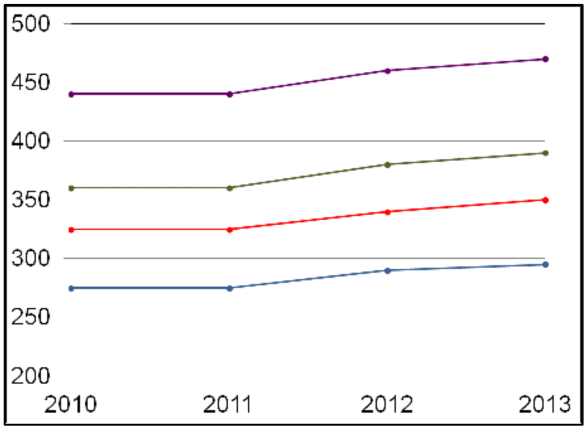
The Fourth Amendment is based on a simple concept, which is to retain the net profit distribution percentages as they have been for the past four years while allowing much more pricing flexibility in order to respond rapidly to market demand and increase overall revenue. Although the concept is simple, Members deserve a thorough explanation.

As Owen Paepke said in the Report to Members: Tying the distribution formula to rack rates has worked reasonably well in the past, but times have changed. Many more of our rooms are booked in the last month or even the last week before arrival than was ever the case in the past. With Internet booking, the rack rate concept is almost dead. Instead, prices are changing week to week, day to day, even hour to hour depending on occupancy numbers. You may have seen this in your airline bookings. If the flight is open, prices drop; if it is nearly booked with a week to go, they skyrocket. Hotels do not usually go that far, and we certainly would not, but we do need the flexibility to fill rooms with lower prices in slack weeks and raise profits with higher prices in heavy weeks. If we are largely booked, a desirable ocean front might be priced like a premium ocean front, or a good ocean view like an ocean front. And so on. Published rack rates tie our hands and therefore reduce distributable income to everyone. But without those published rates, we need some other convenient basis for calculating distributable income without changing the basic financial allocation between the different types of units.

Few Members understand the profit distribution formula in depth. So let's start with the fact that the distribution of net profits to Members of the LLC is **directly coupled** to our **rack rates**, which are the published **maximum** rental rates we can charge in a given year. Within the year there are different rates for the High and the Low Seasons. Therefore, **pricing flexibility** and profit **distribution fairness** can be in conflict. For example, if we lower the Garden View (GV) rate, GV owners will receive proportionately less income and the other units will receive a tiny bit more income. Similarly, if we raise the Premium Ocean Front (POF) rate, the POF owners will receive proportionately more income, but all the other units will receive less income, just because the POF rate was increased, even if we actually rent the POF units at a discount.

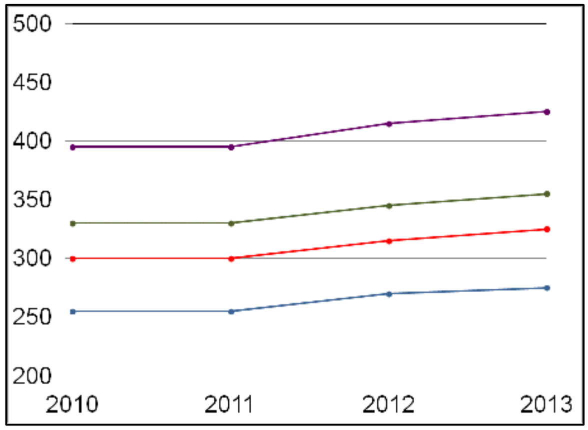
Another way of saying this is that the Managers must consider distribution fairness when setting rental rates. The two charts below show the **rack rates** for POF, OF, OV, and GV units over the past four years for the high season and for the low season. All rates have been moving up to the extent the market will allow. Rack rates are the highest rates we can charge each year, although we can and often do discount below the published rates.

High Season



Four Years of High Season Rack Rates

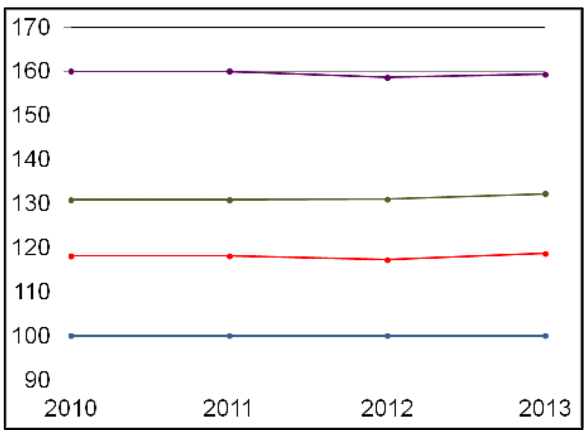
Low Season



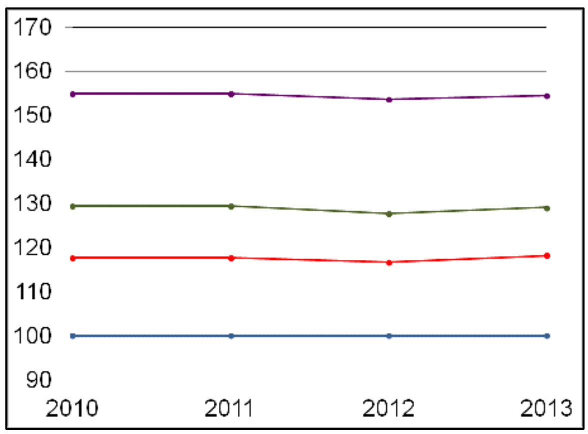
Four Years of Low Season Rack Rates

Ever since the rental program has existed, the **rack rates** also have been the basis for distribution of net income to LLC Members. In other words, the rack rental rates drive the distribution formula. This formula has served us well for many decades. The reason we want to change it now is to **preserve distribution fairness** while permitting very flexible pricing which we believe will lead to **increased income for every Member**.

Although **actual** rack rates have been used in the income distribution formula, what really matters mathematically are the **ratios** of the rack rates. The plots below show these ratios scaled to 100 for Garden View units. (In the charts below, each year the GV rate is divided by the GV rate and the result is multiplied by 100. The OV rate is divided by the GV rate and the result is multiplied by 100, etc. for all the rates.) Note that these ratios have been nearly constant. As a result, the net profit distribution percentages have been nearly constant.



Ratio of High Season Rack Rates



Ratio of Low Season Rack Rates

The table below shows the average ratios for the High and Low seasons over the past four years. There have been only small differences between the high and low season ratios.

High	GV	OV	OF	POF		**Low**	GV	OV	OF	POF
Avg	**100**	**118**	**131**	**159**		**Avg**	**100**	**118**	**129**	**155**

To resolve the small differences, we determined the four-year average of total net income in the high and in the low seasons. The average High Season net income was $370,664 and the average Low Season net income was $381,359. (Because there are more Low Season rental days than High Season rental days, the averages are nearly identical.)

To balance the high and low season ratios, they were scaled by the average amount of income received in each season over the four years. This process established the average ratios over all seasons, and they are:

GV	OV	OF	POF
100	**118**	**130**	**157**

In practice, suppose we have 3 GV, 26 OV, 4 OF, and 14 POF units in the rental program during a year with $1 million dollars of net income. Let's assume no extended use by any owners in that year. In this case the distribution would be determined by:

- $1 million net income to distribute
- Compute 3x100 + 26x118 + 4x130 + 14x157 = 6086
- Divide $1 million by 6086 = $164.3115
- GV units each receive 100 x $164.3115 = $16,431.15
- OV units each receive 118 x $164.3115 = $19,388.76
- OF units each receive 130 x $164.3115 = $21,360.50
- POF units each receive 157 x $164.3115 = $25,796.91

This is essentially identical to how that $1 million would be distributed using our historical rack rates. We are <u>not changing</u> the historic distribution proportions. They are being <u>preserved</u> so we can have very flexible pricing without affecting the historic distribution percentages.

The Managers unanimously consider this reasonable, fair, and acceptable based on the past four years of experience. (The Managers include 3 OV, 2 OF, and 2 POF owners.) We all expect that more pricing flexibility will provide the following benefits:

1. The ability to <u>increase</u> rental rates, at any time, if bookings are strong. Until now we have only had the ability to <u>reduce</u> prices by discounting.

2. The ability to rapidly adjust prices without driving our accountant crazy by having to keep track of week-to-week variable rates using the current distribution formula.

3. The ability to have "from/to" pricing, such as "units are available from $100 to $600." We may offer only one unit at $100, but the low price point can cause those searching for a booking to pause and look at our complete offerings rather than jumping immediately to other properties with a lower starting price.

4. Improves the ability of the Front Office to sell a prospective customer a higher priced unit.

5. Allows us to have more than four price points.

6. Eliminates the need to offer deep discounts at slow times which undermines our price credibility.

We are developing ways to manage and benefit from pricing flexibility, and we would welcome your input on ways to use pricing flexibility to increase profits.

The Fourth Amendment accomplishes these improvements by changing the language of Section 6.1 (A) from:

> <u>Base Rent</u>. The scheduled rental rate of each Rental Unit shall constitute the Base Rent for such Rental Unit.

to:

> <u>Base Rent</u>. The Base Rent shall be $100 for Rental Units L-1, L-2, M-1, M-2, M-3, and M-4. The Base Rent shall be $118 for Rental Units B-1, B-2, B-3, B-4, C-1, C-2, C-3, C-4, D-1, D-2, D-3, D-4, E-1, E-2, E-3, E-4, H-1, H-2, H-3, H-4, K-1, K-2, K-3, K-4, L-3, and L 4. The Base Rent shall be $130 for Rental Units I-2, I-3, J-2, and J-3. The Base Rent shall be $157 for Rental Units A-1, A-2, A-3, A-4, F-1, F-2, F-3, F-4, G-1, G-2, G-3, G-4, I-1, I-4, J-1, and J-4.

No other aspect of the traditional distribution formula is changed.

The Managers unanimously urge you to approve the Fourth Amendment to the LLC Operating Agreement in order to preserve the historic distribution percentages while optimizing profitability for all Members through the use of flexible pricing.