

Office of the City Auditor
Steve Hendrickson, Interim City Auditor

September 11, 2007

Honorable Mayor and Members
of the City Council
200 East Santa Clara Street
San Jose, CA 95113

In accordance with the City Auditor's 2007-08 Workplan, we initiated an audit of the Los Lagos Golf Course. Transmitted herewith is a memorandum, *Initial Review of the Los Lagos Golf Course*, which we sent to Albert Balagso, Director of Parks, Recreation & Neighborhood Services, on September 4, 2007.

I will present this memorandum to the *Public Safety, Finance & Strategic Support Committee* at its September 20, 2007 meeting. If you need any additional information, please let me know. The City Auditor staff member who participated in the preparation of this report is Chris Constantin.

Respectfully submitted,

Steve Hendrickson
Interim City Auditor

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cc: Jay Castellano Deanna Santana
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Memorandum

TO: Albert Balagso, Director of Parks,
Recreation & Neighborhood Services

FROM: Chris Constantin,
Senior Auditor

SUBJECT: *Initial Review of the Los Lagos Golf
Course*

DATE: September 4, 2007

In March 2002, the City of San José signed a 15-year operations and management agreement with CourseCo to operate Los Lagos Golf Course (Los Lagos). CourseCo operates Los Lagos and after paying expenses and retaining a management fee, CourseCo returns all remaining net income to the City on a monthly basis. The City expected Los Lagos to generate enough net income to cover all expenses and virtually all of the debt service payments on the bonds that were sold to fund the construction of Los Lagos.

We found that while Los Lagos generates a net income, it is not sufficient to cover the annual bond payment. Consequently, the City subsidizes a portion of the construction bond. CourseCo cited several external factors that impact its ability to generate sufficient revenue to cover all of the construction bond payments. These factors include:

- The City's feasibility study, prepared by National Golf Foundation Consulting (NGF), estimated the bond cost would be \$14.2 million instead of the actual \$20.7 million;
- The feasibility study underestimated CourseCo employee wages by about \$570,000 per year and significantly underestimated the number of labor hours by about 33,000;
- The feasibility study did not account for the added cost of maintaining environmental mitigation areas within the Los Lagos property;
- Several competing new golf courses opened that were not anticipated by the feasibility study; and
- The disparity between the market conditions the NGF feasibility study assumed and those that prevail today are markedly different. According to golf market analyst Economics Research Associates (ERA):

“Over the 1990-2005 period, the Bay Area public golf inventory has expanded 44 percent compared with 18 percent for the State of California. Bay Area population has increased only 17 percent over this time frame resulting in a substantial decline of nearly 20 percent in the population per golf course...”

Los Lagos' net income projections and historical trends indicate the City will continue to subsidize the Los Lagos bond payments through 2010-11. Los Lagos' net income projections show a general increase from 2006-07 to 2010-11, thereby reducing the estimated share of the City's annual bond payment to \$575,380, or 39 percent of the total bond payment. However, historical evidence does not support Los Lagos' projected net income, which exposes the City to the risk of paying an even larger percentage of future debt service payments.

The Parks, Recreation, and Neighborhood Services Department (PRNS) will conduct an operational review of three municipally-owned golf courses to determine operating efficiencies and opportunities to increase overall economic performance. PRNS estimates a completion date of February 2008. Consequently, we do not recommend duplicating this effort by our office conducting additional audit work of Los Lagos Golf Course.

Scope And Methodology

Councilmember Reed requested a review of Los Lagos Golf Course (Los Lagos) to determine if there is a way to operate the course without losing money. We conducted a preliminary review to assess the need for a full performance audit of Los Lagos.

Specifically, we reviewed audited financial statements for 2003-04 to 2005-06, the Operations and Maintenance Agreement between CourseCo and the City, May 2006 Operational and Financial Report, and interviewed staff. We should note that we primarily relied upon the documentation that the City and CourseCo developed and provided to us. CourseCo provided a listing of program accomplishments attached as Exhibit A.

Los Lagos Audited Financial Statements Show That Its Revenues Cover Los Lagos' Operational Expenses

According to its audited financial statements, Los Lagos operated with surpluses during 2002-03 through 2005-06. The following exhibit highlights Los Lagos' revenues, expenses, and net income for 2002-03 to 2005-06.

Exhibit 1
Los Lagos Golf Course Revenues, Expenses, And Net Income For
2002-03, 2003-04, 2004-05 And 2005-06

	2002-03	2003-04	2004-05	2005-06
Revenue	\$ 3,733,924	\$ 3,763,457	\$ 3,718,572	\$ 3,550,298
Expenditures	\$ 2,986,400	\$ 3,258,269	\$ 3,127,679	\$ 3,140,403
Net Income	\$ 747,524	\$ 505,188	\$ 590,893	\$ 409,895
Net Income As A Percent Of Revenues	20.0 %	13.4 %	15.9 %	11.5 %

Source: Los Lagos Golf Course audited financial statements 2002-03, 2003-04, 2004-05, and 2005-06.

As shown above, Los Lagos generated net incomes ranging from almost \$750,000 in 2002-03 to about \$410,000 in 2005-06. In 2005-06, golf fees represented the largest revenue source for Los Lagos at \$1,868,374, or 53 percent of total revenue. Golf course maintenance represented the largest expenditure at \$1,178,724, or 38 percent of total expenditures.

The City Will Continue Subsidizing The Los Lagos Bond Debt Service Payments

Los Lagos net income projections and historical trends indicate the City will continue to subsidize the Los Lagos bond debt through 2010-11. In a March 13, 2002 memorandum to the City Council, PRNS staff stated that Los Lagos will be *“essentially self-supporting over at least the first six years of its operations ... annual net operating income from the golf course should be sufficient to fund virtually all of its obligations and to generate an operating surplus in future years.”* Audited financial statements confirm that Los Lagos’ revenues support its operations. However, performance during the past four years and Los Lagos income and expense projections through 2010-11 clearly indicate that Los Lagos will not generate sufficient net income to pay the entire bond payment.

According to CourseCo’s May 2006 Operational and Financial Report, several factors impacted Los Lagos’ ability to generate enough net income to cover the full construction bond payments. These factors include:

- The City’s feasibility study, prepared by NGF Consulting, estimated the bond cost would be \$14.2 million instead of the actual \$20.7 million;
- The feasibility study underestimated CourseCo employee wages by about \$570,000 per year and significantly underestimated the number of labor hours by about 33,000;
- The feasibility study did not account for the added cost of maintaining environmental mitigation areas within the Los Lagos property;
- Several competing new golf courses opened that were not anticipated by the feasibility study; and
- The disparity between the market conditions the NGF feasibility study assumed and those that prevail today are markedly different. According to Economics Research Associates (ERA), a golf market analyst:

“Over the 1990-2005 period, the Bay Area public golf inventory has expanded 44 percent compared with 18 percent for the State of California. Bay Area population has increased only 17 percent over this time frame resulting in a substantial decline of nearly 20 percent in the population per golf course...”

According to Los Lagos’ net income projections, the City will continue subsidizing the bond payment to a cost of about \$600,000 to \$800,000 annually. The following exhibit shows the annual estimated bond payment, Los Lagos’ projected net income, and the City’s projected debt payments for 2006-07 through 2010-11.

Exhibit 2
City's Portion Of The Bond Debt Based On Los Lagos
Net Income Projections For 2006-07 Through 2010-11¹

Year	2006-07	2007-08	2008-09	2009-10	2010-11
Estimated Bond Debt Payment	\$1,402,644	\$1,417,839	\$1,431,624	\$1,443,999	\$1,459,964
Los Lagos Projected Net Income ²	\$592,890	\$619,753	\$692,404	\$770,576	\$884,584
Remaining Bond Debt Payment	\$809,754	\$798,086	\$739,220	\$673,423	\$575,380
City Percent Of Total Debt Payment	58%	56%	52%	47%	39%

Source: Finance records and Los Lagos projections.

Los Lagos projections show a general increase in net income from 2006-07 to 2010-11. As a result, in 2010-11, Los Lagos projects that the City will pay \$575,380 for bond debt service, or 39 percent of the total bond debt payment.

We conducted limited reasonableness testing on Los Lagos' revenue projections through 2010-11. Specifically, while Los Lagos revenues have dropped during the past two years, Los Lagos projects revenue increases during the next five years. The following exhibit shows Los Lagos' total revenue and rounds of golf for 2002-03 through 2005-06 and Los Lagos five-year revenue and rounds of golf projections for 2006-07 through 2010-11.

Exhibit 3
Los Lagos' Actual Revenue And Rounds Of Golf From 2002-03 Through 2005-06 And
Los Lagos' Projected Revenue And Rounds Of Golf For 2006-07 Through 2010-11

Fiscal Year ³	Total Revenue ⁴	Percent Change	Number Of Rounds	Percent Change
2002-03 (1)	\$3,714,846		69,460	
2003-04 (1)	\$3,746,047	0.8%	68,781	-1.0%
2004-05 (1)	\$3,684,979	-1.6%	68,544	-0.3%
2005-06 (1)	\$3,512,578	-4.7%	65,843	-3.9%
2006-07 (2)	\$3,902,641	11.1%	70,000	6.3%
2007-08 (2)	\$ 4,040,136	3.5%	71,000	1.4%
2008-09 (2)	\$4,238,700	4.9%	72,250	1.8%
2009-10 (2)	\$4,448,017	4.9%	73,500	1.7%
2010-11 (2)	\$4,696,802	5.6%	75,000	2.0%

Source: Finance records and Los Lagos projections.

¹ We adjusted Los Lagos' Projected Net Income for 2009-10 and 2010-11 due to a calculation error in CourseCo's projections. The net result shows an increased net income.

² Assumes all projected net income after management fee, mitigation expenses, and capital reserve fund will be contributed to bond debt payment.

³ Actual (1) and Projected (2).

⁴ Total revenue amounts in Exhibit 3 differ from Exhibit 1. Exhibit 3 includes only operations revenue while Exhibit 1 includes other revenue such as interest and miscellaneous income.

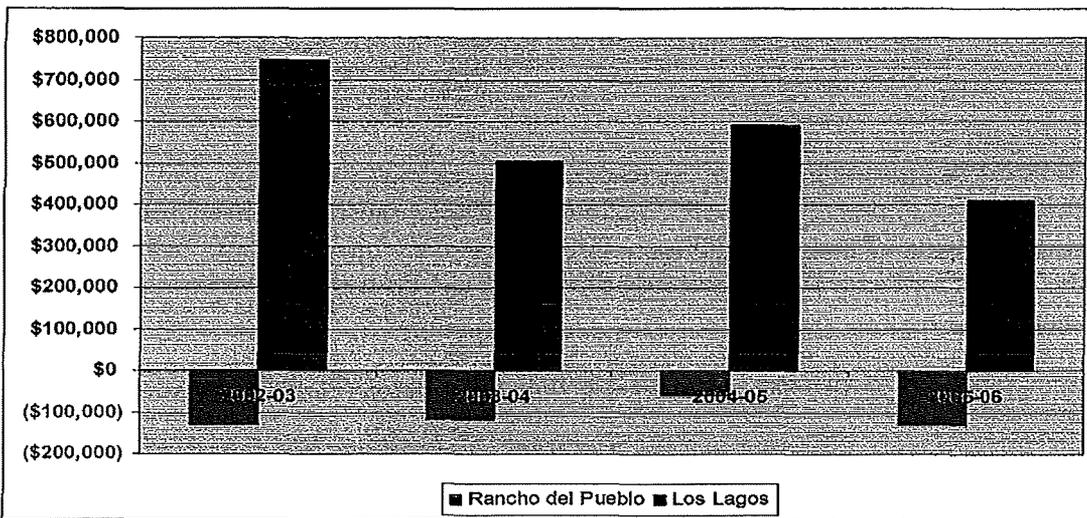
As shown in Exhibit 3, actual 2002-03 through 2005-06 trends do not support Los Lagos' revenue projections for 2006-07 through 2010-11. Specifically, Los Lagos projects an 11.1 percent revenue increase from 2005-06 to 2006-07 even though actual revenue decreased 4.7 percent from 2004-05 to 2005-06. Similarly, while the rounds of golf dropped by 5.2 percent from 2002-03 to 2005-06, Los Lagos' projection for 2006-07 and beyond assumes a higher number of rounds played than any of the prior four years.

In our opinion, Los Lagos reports do not provide sufficient justification for its optimistic revenue and rounds of golf projections for 2006-07 through 2010-11. City staff should scrutinize Los Lagos' revenue and rounds of golf projections for 2006-07 through 2010-11 before asking the City Council to make any policy decisions regarding Los Lagos.

Los Lagos Significantly Outperforms Rancho del Pueblo

Los Lagos significantly outperforms Rancho del Pueblo, another City golf course that CourseCo operates for the City. Rancho del Pueblo's audited financial statements show operating losses for the past four years. In 2005-06, Rancho del Pueblo had a net loss of about \$131,000 compared to Los Lagos' nearly \$410,000 net income. The following exhibit shows a comparison of net income or loss for Rancho del Pueblo and Los Lagos from 2002-03 through 2005-06.

Exhibit 4
Comparison Of Net Income Or Loss For Rancho del Pueblo And
Los Lagos Golf Courses From 2002-03 Through 2005-06



Source: Rancho del Pueblo and Los Lagos audited financial statements.

While Los Lagos covered its operating expenses, Rancho del Pueblo experienced operating losses. Further, according to a CourseCo official, it assigns \$30,000 to \$40,000 per year of Rancho del Pueblo general management costs to Los Lagos. This has the effect of reducing both Rancho del Pueblo's net operating loss and Los Lagos' net income. According to PRNS, the combined management reduces the operating costs of both facilities as both require expensive

specialized staff which can be shared. In our opinion, while combined management may reduce operating costs, the assignment of cost to the proper entity would present a clearer picture of operations.

National Golf Foundation Survey Indicates Los Lagos Exceeded National Average And Local Courses For Course Conditions And Customer Satisfaction

CourseCo reports that Los Lagos exceeded the course quality and customer satisfaction ratings when compared to the national average and similar local golf courses. CourseCo conducted three successive annual National Golf Foundation surveys on golf course conditions and customer satisfaction. The National surveys allowed CourseCo to compare Los Lagos' results to other golf courses such as Santa Teresa, San Jose Municipal, and the national average. The following exhibit highlights the percentage of surveyed customers who rated overall course conditions as either somewhat favorable or very favorable. We should note that CourseCo conducted and reported the results of the survey. Consequently, we cannot attest to the validity of the results.

Exhibit 5
Percentage Of Surveyed Respondents Who Rated The Golf Courses'
Conditions As Either Somewhat Favorable Or Very Favorable

	2003	2004	2005
Los Lagos	89%	94%	93%
Santa Teresa	70%	68%	81%
San José Municipal	60%	49%	67%
National Average	76%	73%	70%

Source: CourseCo Operational and Financial Report, May 2006.

As shown above, Los Lagos significantly outperformed the national average and the two local public golf courses. Additionally, CourseCo measured customer satisfaction in subcategories of overall experience, value of course, condition of greens, and friendliness of staff. Los Lagos exceeded the ratings for Santa Teresa, San José Municipal, and the national average in all of these subcategories.

PRNS Will Conduct An Operational Review Of Three Municipal Golf Courses

According to PRNS, PRNS will conduct an operational review of all three municipally-owned golf courses – San José Municipal, Los Lagos, and Rancho del Pueblo. PRNS initiated a process to identify a consultant and perform a review of all three municipally-owned golf courses. PRNS anticipates a final report date of February 2008.

The goal of the operational review is to determine operating efficiencies and opportunities to increase overall economic performance. Specifically, the review's scope includes, but is not limited to a(n):

- Evaluation of operational structure;
- Benchmarking of pricing and benchmarking with appropriate standards;
- Review of factors contributing to Los Lagos and Rancho del Pueblo golf courses not reaching goals originally set for them; and
- Evaluation of funding and operational alternatives.

In our opinion, PRNS's use of an expert to conduct this review will address the Mayor and City Council's concern regarding golf course performance. Consequently, we do not recommend duplicating this effort by conducting additional audit work on Los Lagos Golf Course.

Conclusion

The Los Lagos Golf Course operations generate a surplus; however, the City will continue to pay a significant portion of the bond payments. Further, Los Lagos' revenue and rounds of golf projections for 2006-07 through 2010-11 appear to be optimistic. In our opinion, City staff should scrutinize Los Lagos revenue and rounds of golf projections for 2006-07 through 2010-11 before asking the City Council to make any policy decisions regarding Los Lagos.

PRNS will conduct an operational review of all three municipally-owned golf courses to determine operating efficiencies and opportunities to increase overall economic performance. PRNS estimates a completion date of February 2008. Consequently, we do not recommend duplicating this effort by conducting additional audit work on Los Lagos Golf Course.



Chris Constantin
Senior Auditor

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Deanna Santana
Cindy Rebhan
Heidi York

Exhibit A

**Awards Received for Los Lagos
Golf Course and Rancho del Pueblo
Golf Course**

Los Lagos

2003

Chapter Award Winner

GCSAA/Golf Digest Environmental Leaders in Golf
Alan Andreasen, CGCS

Top 10 Facility – Daily Fee Category

NGF Customer Loyalty and Satisfaction Program

Clubfitter of the Year

Northern California Section PGA

Matt Flenniken, PGA

2004

Chapter Award Winner

GCSAA/Golf Digest Environmental Leaders in Golf
Alan Andreasen, CGCS

Top 10 Facility – Daily Fee Category

NGF Customer Loyalty and Satisfaction Program

**Recognized as a Certified Audubon Cooperative
Sanctuary**

Audubon International

2005

National Award Winner

GCSAA/Golf Digest Environmental Leaders in Golf
Alan Andreasen, CGCS

Excellence in Turfgrass Award Winner

Northern California GCSAA

Alan Andreasen, CGCS

**Commendation for “Exemplary work at Los Lagos
Golf Course to incorporate environmental principles
that successfully balance the goals of habitat
preservation, community recreation, and open space”**

City of San Jose – Councilmember Linda LeZotte

Alan Andreasen, CGCS

Top 10 Facility – Daily Fee Category
NGF Customer Loyalty and Satisfaction Program
Horton Smith Award Winner
Northern California Section PGA
Janet Davis, PGA

2006
Commendation for “Innovative vision, environmental design and operations and customer service.”
City of San Jose – Councilmember Madison Nguyen
Player Development Award
National Golf Course Owners Association

2007
Top 20 Most Admired Golf Operators
Golf, Inc. Magazine
Scot Hathaway, PGA

Rancho del Pueblo

2005
ZONE Rookie of the Year
The First Tee
The First Tee of San Jose
Telischak Award Winner
CourseCo, Inc
Long Nguyen
Recognized as a Certified Audubon Cooperative Sanctuary
Audubon International

2006
Player Development Award
National Golf Course Owners Association