Follow Up on Real Estate Options

April 15, 2019

In the January 2019 board meeting, staff were directed to develop analysis around four potential options for the Trust Real Estate portfolio. Those options are:

Option One: Maintain Status Quo

Under this scenario, the Trust would retain ownership of seven investment properties using principal. Based on the 2019 budgets, the portfolio is expected to generate gross rents of $12.1 million and net operating income (excluding depreciation) of $5.7 million. From the operating income, $1.9 million would be used to repay principal on the outstanding mortgages and $1.6 million would be reinvested to fund tenant improvements, leasing commissions, and other capitalized expenses. The remaining $2.2 million would potentially be available to distribute for the support of Trust programs.

Maintaining the portfolio provides the following benefits to the Trust:

- Potential for properties to appreciate in value. As demonstrated by the IRS building, the Trust can create value by securing long term leases with high quality tenants.
- Cash distributions may grow as mortgages are repaid and debt service requirements decrease. Lease renewals also create opportunities to increase lease rates and generate more cash flow.
- Real estate values may move independently of broader financial markets, creating some hedging protection to the overall Trust portfolio. Historically, the real estate asset class as a whole has also provided some protection in an inflationary environment. The rental income stream also provides some protection from potentially volatile commodity prices and increases the stability of the Trust Land Office revenues.

Maintaining the portfolio also requires consideration of the following factors:

- Specific properties have investment needs to modernize the facilities and retain key tenants. Making these investments may reduce cash available for supporting programs.
- Three properties are leased to either single tenants or to a small number of users. This creates some level of concentration risk if tenants choose to vacate or their business model is not successful.
- Real estate valuations can be very sensitive to the overall interest rate environment and the availability of financing. A rising interest rate environment or a disruption to the financial markets may create downward pressure on the portfolio values.
- This approach does not satisfy the special audit recommendation.

Option Two: Manage the Portfolio through APFC

Under this scenario, the Trust would transfer the investment properties into a separately managed account at the Permanent Fund. APFC would retain a qualified real estate investment firm that would oversee the properties and provide reports to the Trust. The Trust would not be involved in the operations of the properties, but would retain final authority over the purchase or sale of any assets.

Expected revenues from the properties would remain as projected in the 2019 budgets, the portfolio is expected to generate gross rents of $12.1 million and net operating income (excluding depreciation) of $5.7 million. From the net income, the Trust would pay an asset management fee of 45 basis points (0.45%) on the gross value of the portfolio (approximately $100 million) and certain costs associated with valuing the portfolio (appraisals, holding company audits, etc.); these expenses would be approximately $700,000. From the remaining $5 million, $1.9 million would be used to repay principal on the outstanding mortgages and $1.6 million would be used for improvements to the property. The remaining $1.5 million would be available for distribution to support trust programs.

This approach provides the following benefits to the Trust:

- Potential for properties to appreciate in value. As demonstrated by the IRS building, the Trust can create value by securing long term leases with high quality tenants.
- Cash distributions may grow as mortgages are repaid and debt service requirements decrease. Lease renewals also create opportunities to increase lease rates and generate more cash flow.
- Real estate values may move independently of broader financial markets, creating some hedging protection to the overall Trust portfolio. Historically, the real estate asset class as a whole has also provided some protection in an inflationary environment. The rental income stream also provides some protection from potentially volatile commodity prices and increases the stability of the Trust Land Office revenues.
- Additional oversight and reporting will be available for these investments without placing additional workload on TLO staff.
- Fulfills recommendations made by the Legislative Audit without committing the Trust to a long term management agreement.

Taking this action also requires consideration of the following factors:

- Additional costs from hiring an outside manager will reduce cash available for distribution to support programs. We may experience a "learning curve" during the transition which could negatively impact results.
- Specific properties have investment needs to modernize the facilities and retain key tenants. Making these investments may reduce cash available for supporting programs.
- Three properties are leased to either single tenants or to a small number of users. This creates some level of concentration risk if tenants choose to vacate or their business model is not successful.
- Real estate valuations can be very sensitive to the overall interest rate environment and the availability of financing. A rising interest rate environment or a disruption to the financial markets may create downward pressure on the portfolio values.

<u>Option Three: Retain Real Estate and Replace Previously Invested Principal with Funding from Reserves</u>

The Legislative Audit concentrates attention on $39.5 million in principal that is invested in the real estate portfolio. The Trust would transfer an equivalent amount of money from available, spendable reserves into the restricted portion of the Trust fund portfolio at the Permanent Fund. The intended outcome of this action would be to extinguish concerns around the use of principal and demonstrate that all of the funds invested in the property are coming from clearly spendable sources, well within the

trustees' authority to allocate. The Trust would retain the investment properties and continue to manage them through the Land Office.

This approach provides the following benefits to the Trust:

- Potential for properties to appreciate in value. As demonstrated by the IRS building, the Trust can create value by securing long term leases with high quality tenants.
- Cash distributions may grow as mortgages are repaid and debt service requirements decrease. Lease renewals also create opportunities to increase lease rates and generate more cash flow.
- Real estate values may move independently of broader financial markets, creating some hedging protection to the overall Trust portfolio. Historically, the real estate asset class as a whole has also provided some protection in an inflationary environment. The rental income stream also provides some protection from potentially volatile commodity prices and increases the stability the Trust Land Office revenues.
- Funds transferred from the reserve account into the principal portion of the account will continue to be invested and generate funds to support programs. The Trust will continue to be able to draw an annual 4.25% from these investments to support programs.
- Management believes this action will satisfy the special audit recommendation.

Taking this action also requires consideration of the following factors:

- The funds transferred will be permanently restricted and cannot be spent outside of the annual 4.25% draw.
- The Trust has established a reserve target of 400% of annual budget; approximately $117.75 million. As of February 28, 2019 the reserve accounts were approximately $164 million. Considering the impact of this transfer ($39.5 million) along with the earlier allocations to support facility needs ($4.8 million) and the potential TLODA projects ($8 million) approximately $52.3 million in reserves will be deployed. This will reduce Trust reserve levels to approximately $111.7 million, or roughly 95% of the target amount. Comparing this lower amount to the FY19 base budget, the Trust would have 375% of the base budget available in reserves. Potential strategies for resolving this may include updating the 400% threshold to reflect current Trust needs and industry standards, making several smaller transfers over time rather than a lump sum, earmarking future proceeds from the properties to replenish the reserve accounts, or reducing annual portfolio distributions to allow the reserves to rebuild.
- The Trust will retain responsibility for funding capital improvements and other costs associated with holding the assets.

Option Four: Retain Real Estate and Establish A Replacement Schedule for Invested Principal

An alternative approach to addressing the questions around the use of principal would be to commit to an additional transfer to the Permanent Fund each year, based on funds generated from the real estate investments. The current forecast for the portfolio indicates free cash flow of $2.2 million, which will increase over time as the mortgages are paid down and the lease agreements renew at higher rates. If the portfolio continues to generate favorable results, the trustees could direct that these resources be used to replace the principal currently invested in the real estate. Using current income, this could be accomplished over a 15 year time frame, with the potential for earlier completion if a property is sold.

This approach provides the following benefits to the Trust:

- Potential for properties to appreciate in value. As demonstrated by the IRS building, the Trust can create value by securing long term leases with high quality tenants.
- Cash distributions may grow as mortgages are repaid and debt service requirements decrease. Lease renewals also create opportunities to increase lease rates and generate more cash flow.
- Real estate values may move independently of broader financial markets, creating some hedging protection to the overall Trust portfolio. Historically, the real estate asset class as a whole has also provided some protection in an inflationary environment.
- The replacement schedule is a soft commitment from the Trust and the transfer amount can be adjusted up or down depending on future financial circumstances.
- Management believes that this action addresses the special audit recommendation slowly, but surely.

Taking this action also requires consideration of the following factors:

- Specific properties have investment needs to modernize the facilities and retain key tenants. Making these investments may reduce cash available for supporting programs.
- Three properties are leased to either single tenants or to a small number of users. This creates some level of concentration risk if tenants choose to vacate or their business model is not successful.
- Real estate valuations can be very sensitive to the overall interest rate environment and the availability of financing. A rising interest rate environment or a disruption to the financial markets may create downward pressure on the portfolio values.
- Income from the real estate portfolio would not be available to support program needs for the foreseeable future. This financial compression may restrict the program budget in future years.
- A series of payments over 15 years may not satisfy the stakeholders that are concerned with the real estate portfolio. More immediate action has a higher likelihood of addressing any remaining concerns around the audit report.

The following tables are estimates of financial performance for the portfolio in 2019 and the following years. The major variable in the projected cash flows are the potential tenant improvement and lease commission expenses. There is a schedule loan maturity for North Park in FY2022 is reflected in the high amount of principal payments shown during that year. Refinancing this mortgage may be pursued after the portfolio strategy has been determined.

The following pages provide a side by side comparison of the financial effects of each option.

Financial Comparison of Options One through Four

Option One: Maintain Status Quo	2019	2020	2021	2022	2023	5 Year Summary
Income	12,579,594	12,831,186	13,087,810	13,349,566	13,616,557	65,464,713
Expenses	4,539,929	4,630,728	4,723,342	4,817,809	4,914,165	23,625,974
Interest	1,904,687	1,983,969	1,898,212	1,624,119	1,410,602	8,821,590
Total Operating Expenses	6,444,616	6,614,697	6,621,555	6,441,929	6,324,767	32,447,564
Net Operating Income (ex. Dep)	6,134,978	6,216,489	6,466,255	6,907,637	7,291,790	33,017,149
Principal Payments on Mortgages	1,924,555	1,821,761	1,907,537	8,082,384	1,794,076	15,530,312
Cap. Ex./Tenant Imp./Lease Comm.	1,555,396	1,500,000	1,500,000	1,500,000	850,000	6,905,396
Building Reserve Deposits	86,400	86,400	86,400	86,400	86,400	432,000
Estimated Free Cash Flow	2,568,627	2,808,328	2,972,318	(2,761,147)	4,561,314	10,149,441

Option Two: Manage through Permanent Fund Corporation	2019	2020	2021	2022	2023	5 Year Summary
Income	12,579,594	12,831,186	13,087,810	13,349,566	13,616,557	65,464,713
Expenses	4,539,929	4,630,728	4,723,342	4,817,809	4,914,165	23,625,974
Interest	1,904,687	1,983,969	1,898,212	1,624,119	1,410,602	8,821,590
Total Operating Expenses	6,444,616	6,614,697	6,621,555	6,441,929	6,324,767	32,447,564
Net Operating Income (ex. Dep)	6,134,978	6,216,489	6,466,255	6,907,637	7,291,790	33,017,149
Principal Payments on Mortgages	1,924,555	1,821,761	1,907,537	8,082,384	1,794,076	15,530,312
Cap. Ex./Tenant Imp./Lease Comm.	1,555,396	1,500,000	1,500,000	1,500,000	850,000	6,905,396
Building Reserve Deposits	86,400	86,400	86,400	86,400	86,400	432,000
Estimated Free Cash Flow	2,568,627	2,808,328	2,972,318	(2,761,147)	4,561,314	10,149,441
Payment to Fund Manager	450,000	450,000	450,000	450,000	450,000	2,250,000
Compliance Expenses	250,000	250,000	250,000	250,000	250,000	1,250,000
Available Cash Flow	1,868,627	2,108,328	2,272,318	(3,461,147)	3,861,314	6,649,441

Option Three: Replace Principal Investment Using Reserves							
	2019	2020	2021	2022	2023		5 Year Summary
Income	12,579,594	12,831,186	13,087,810	13,349,566	13,616,557		65,464,713
Expenses	4,539,929	4,630,728	4,723,342	4,817,809	4,914,165		23,625,974
Interest	1,904,687	1,983,969	1,898,212	1,624,119	1,410,602		8,821,590
Total Operating Expenses	6,444,616	6,614,697	6,621,555	6,441,929	6,324,767		32,447,564
Net Operating Income (ex. Dep)	6,134,978	6,216,489	6,466,255	6,907,637	7,291,790		33,017,149
Principal Payments on Mortgages	1,924,555	1,821,761	1,907,537	8,082,384	1,794,076		15,530,312
Cap. Ex./Tenant Imp./Lease Comm.	1,555,396	1,500,000	1,500,000	1,500,000	850,000		6,905,396
Building Reserve Deposits	86,400	86,400	86,400	86,400	86,400		432,000
Estimated Free Cash Flow	2,568,627	2,808,328	2,972,318	(2,761,147)	4,561,314		10,149,441

Option Four: Replace Principal Investment Using Payment Plan (Income out of the Portfolio)							
	2019	2020	2021	2022	2023		5 Year Summary
Income	12,579,594	12,831,186	13,087,810	13,349,566	13,616,557		65,464,713
Expenses	4,539,929	4,630,728	4,723,342	4,817,809	4,914,165		23,625,974
Interest	1,904,687	1,983,969	1,898,212	1,624,119	1,410,602		8,821,590
Total Operating Expenses	6,444,616	6,614,697	6,621,555	6,441,929	6,324,767		32,447,564
Net Operating Income (ex. Dep)	6,134,978	6,216,489	6,466,255	6,907,637	7,291,790		33,017,149
Principal Payments on Mortgages	1,924,555	1,821,761	1,907,537	8,082,384	1,794,076		15,530,312
Cap. Ex./Tenant Imp./Lease Comm.	1,555,396	1,500,000	1,500,000	1,500,000	850,000		6,905,396
Building Reserve Deposits	86,400	86,400	86,400	86,400	86,400		432,000
Estimated Free Cash Flow	2,568,627	2,808,328	2,972,318	(2,761,147)	4,561,314		10,149,441
Return of Principal	1,284,314	1,404,164	1,486,159	-	2,280,657		6,455,294
Available Cash Flow	1,284,314	1,404,164	1,486,159	(2,761,147)	2,280,657		3,694,147