MEMORANDUM

To: AMHTA Board of Trustees

From: Greg Jones

Date: May13, 2020

Re: Historical Perspective on the Trust's Real Estate Investments

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Mike Abbott and Laraine Derr asked me to assist in the Trust in a planned work session about the Trust's real estate investments. They did so because I was involved in the preparation and initial execution of the Trust's Real Estate Management Plan (REMP) as a component of the broader Asset Management Plan.

There are apparently three fundamental questions that have been raised that will be addressed in the work session.

1. What led the Trust to decide to invest in commercial real estate?
2. Why did the Trust believe it could use cash generated from the disposal of principal assets to acquire commercial real estate?
3. Why did the Trust finance commercial real estate by acquiring debt and why did they choose amortized debt over interest only debt?

Background

The following is a historical review and a summary of the thought process that was employed as the decisions were made to invest in real estate. I am not a lawyer, so this summary is in layman's terms. Where questions of law arise, what is said here is based on my understanding of the law as told to me by a number of lawyers for both the Trust and the State of Alaska. There were many important facts and details that are not covered here, as they are not germane to the Trust's real estate investments.

In 1956 Congress passed Public Law 84-830 which created the Alaska Mental Health Trust as a "Public Trust" and endowed it with one million acres of land, to be chosen on behalf of the Trust with priority over other agencies and local governments. The land was to be used to generate income for use in funding mental health programs. The Alaska Legislature originally acted as trustee for the Trust. In 1982 the State of Alaska was sued for failing to use the Trust's assets for the benefit of the beneficiaries of The Trust and not acting to protect the assets of the Trust and, in fact, giving away or selling almost half of the land assets to a variety agencies, local governments and private entities.

In 1984 the judge ruled and the State lost the case. It took until 1994 to negotiate the terms of the settlement. Among other things, the settlement did the following:

- Stripped the Legislature of the responsibility and authority to act as trustee for the Trust.
- Required that the half million acres of Trust land that the State had disposed of be replaced.

- Awarded the Trust $200M in damages.
- Ordered the creation of a semi-autonomous authority to manage the Trust including its assets.

Since there was no Trust staff or other administrative infrastructure of any kind, the parties to the settlement agreed that the $200M would initially be given to the Alaska Permanent Fund Corporation (APFC) to manage. This was an understandable decision. Without an organization and staff, there was no one to manage the fund.

In perhaps the most unusual provision of the settlement, the million acres of land was handed to a dedicated and autonomous agency under the umbrella of the Department of Natural Resources – The Trust Land Office (TLO). The terms of the settlement stated that the agency is not to manage the land in the interest of the public. The land is to be managed purely for the benefit of the beneficiaries of the Trust. The TLO is to consult with the Trust, but the TLO's decisions are final. The TLO's decisions on management of the Trust's assets are not appealable administratively – not to the Commissioner of DNR or to the Trustees. Its decisions can only be appealed to court.

In reading the notes, memos and other papers associated with the settlement of the lawsuit, it is apparent that these two provisions were included due to the lack of other options. It is also clear that it was assumed that these provisions could be changed, amended, or revoked as the Trust developed its capabilities as an organization, but any changes would have to be made by statute.

Finally, the Trust was given the responsibility for overseeing the development of the Department of Health and Social Services' mental health budget on an annual basis and leading the development of the State's Comprehensive Integrated Mental Health Program Plan.

After the settlement was finalized, the Trust and the Trust Land Office set about building their respective organizations. The next decade was generally successful for both organizations. The Trust established its place in the State's process of planning and executing the Comprehensive Integrated Mental Health Program Plan and the Trust Land Office worked on cataloguing the Trust's varied assets and began to produced revenue, primarily through the disposal of Trust assets.

It is important to remember that revenue generated from those assets falls into two categories. Principal revenue comes from the disposal of assets, normally through a sale or royalty. Income revenue is produced with rents, fees and other non-disposal transactions. Only the income revenue can be used by the Trust to pay its administrative costs and fund its programs. Principal revenue must ultimately be deposited in the Trust Fund.

In its initial years leading up to 2009, the Trust's accomplishments were impressive. In addition to closing Morningside Hospital in Oregon [1]. They also launched a Bring the Kids Home initiative

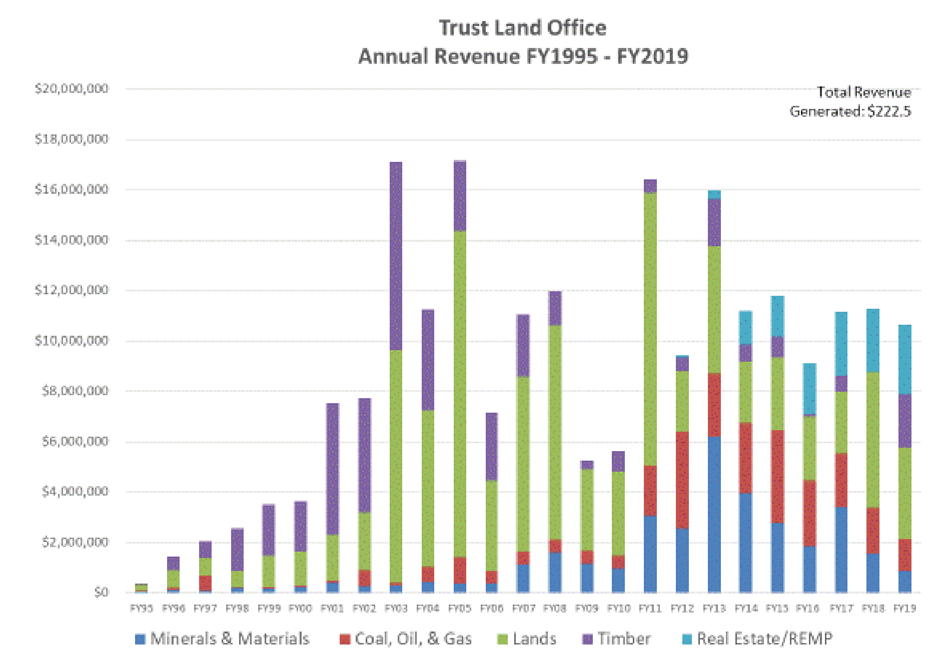
[1] **From AMHTA Website:** Prior to statehood in 1959, there were few mental health services available in the territory of Alaska for individuals who experienced mental illness or developmental disabilities. At the time, mental illness was considered a crime. People with any sort of mental disability

which focused on returning children to Alaska who had been sent out of state due to a perceived lack of treatment capability here. The Trust was regularly achieving positive results in addressing a number of other mental health related issues including, but not limited to, addiction, homelessness, youth advocacy and mental health issues related to the prison system. During that same period, the TLO had raised almost $150,000,000 in principal revenue through land sales and royalties from resource development on Trust Land. The Trust Fund held by the APFC had grown to over $400,000,000 as a result of deposits from the TLO's asset sales and from investment gains reported by the APFC.

However, things began to change. While the Trust continued to make progress on mental health issues through the decade, the Permanent Fund began to suffer lower than expected returns due to the stock market woes associated with the Great Recession of 2008-2013. In addition, revenue generated by the TLO was falling off rapidly due to a combination of factors. The timber supply on Trust land, which was the source of much of the revenue in the first years of the new Trust Authority, was nearly exhausted. Much of the best land had been sold off. The only bright spot was resource values, but they were known to be volatile.

By 2009 there was growing concern on the part of the Trustees that revenue and, more important, the income from Trust assets was dwindling, as shown on Graph # 1 below. That income was essential to fund the Trust's program priorities.

Graph # 1



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who were unable to care for themselves or who could not be cared for by a family member or guardian were charged and convicted as "an insane person at large." Those convicted of this crime were sent by the federal government to live in Morningside Hospital, a private institution in Oregon. By 1942, more than 2,000 people from Alaska, including very young children, were residing there.

Backing up a bit, it is important to look at a few salient events and practices that had taken place at the Trust and TLO. In 1999, the Board of Trustees passed a resolution (Res. 00-03, Appendix A) to transfer all revenue allocated as Principal to the APFC. But in 2001 that resolution was amended (Res. 03-01, Appendix B) to direct the quarterly transfer "unless authorized differently by actions of the trustees." What became the Trust Authority Development Account (TADA) was created during that time and funds were held there prior to depositing them into the Trust Fund at the APFC.

During the ensuing years, the TLO with the concurrence of the Trustees, would on occasion use funds from the TADA to enhance Trust lands. This was supported by both statute and regulation.[2] The rationale was that they were using one form of Trust principal (cash) to enhance the value of another form of Trust principal (land). These enhancements would typically include subdivision costs, access road construction, mineral surveys or permitting costs among other things. In all cases, the goal was to add value to Trust land that would be harvested through land and resource sales. The alternative would have been to use income revenue to do the work of enhancing the value of the noncash assets. This would take money away from programs and thus negatively impact the beneficiaries of the Trust. Thus, the Trust, through the TLO, began to invest principal outside of the Trust Fund managed by the APFC. As they sold off the "low hanging fruit", more and more land required some sort of preliminary investment to prepare it for sale.

Why Real Estate?

This was happening as the 2008 recession started. The Trustees and the TLO began to realize that a different approach to funding the Trust's mental health agenda was needed in order for it to be sustainable.

The concept of a "Real Estate Program" emerged in early 2010 to address that need. After exploring several alternatives, it became apparent that, if executed in accordance with strict and conservative investment policies, commercial real estate leasing income had the greatest potential of meeting the needs of current and future beneficiaries while producing the lowest risk factors. For the next two years the Trustees met numerous times with staff and the Trust's lawyers to discuss and analyze the legal ramifications of using principal revenue for funding the acquisition of commercial real estate. Those discussions are well documented in the Trust's files and records of their proceedings. In general terms, what was learned was that state statutes are not clear on subject of the uses of principal for investing in Trust assets, but trust case law in general indicates that it should be interpreted to permit such investments in light

[2] **20 AAC 40.700 Real property development accounts** (a) From time to time, the board may determine that it is in the interest of the trust and its beneficiaries to use receipts from the management of trust land to (1) acquire for the trust new trust land; or (2) improve or develop existing trust land. (b) The board will make a decision under (a) of this section in accordance with the applicable provisions of the *Asset Management Policy Statement* adopted by reference in 20 AAC 40.600. (c) If the board decides under (a) of this section to acquire new trust land or to improve or develop existing trust land, the authority will establish a development account for the purpose of monitoring and accounting for the receipts used and the costs incurred by the trust to carry out that acquisition, improvement, or development project. (d) The authority will maintain a development account established under (c) of this section until the project for which the account was established has been complete.

of the Trustees affirmative obligation in both state statute and federal law to enhance Trust assets.

In light of the Trust's perceived need for both investment diversity and income, the TLO wrote and adopted the Real Estate Management Program (REMP) that was unanimously accepted by the Trustees June, 2012, and shortly thereafter published with a written finding and public comment period.

The REMP identified an overall strategy for generating cash flow from income producing properties. In addition, the plan addressed risk, project profile, investment return, investment criteria and goals and objectives for the plan. The plan went through an identical process in November, 2013, when the TLO published the Resource Management Strategy. Again, in 2015 the plan was amended and again when through a public notice and solicitation of comments and input. The TLO did not receive any comments or objections during any of these public comment periods.

Subsequent to the initial publication of the REMP, the TLO began to invest in high quality commercial real estate. After purchasing their own office building, the first pure investment was a facility in Anchorage that was owned and occupied by Cummins Diesel, a Fortune 500 company. Cummins had decided to sell their service centers nationwide and lease them back. While that investment was small, it was valuable in allowing the TLO, the Trust and the Department of Revenue to go through the process of making the investment and setting up the management.

One of the recommendations of the REMP was to achieve geographic diversity. With that in mind, the TLO began looking for high quality investments outside of Alaska. The next acquisition was a facility occupied by the Internal Revenue Service in Ogden Utah. Next, a building leased to the State of Washington as the headquarters of State Parks Department was acquired. Additional buildings were purchased in Texas that are leased to excellent credit tenants, including the State of Texas Department of Transportation.

The Trust's new real estate advisor has given this real estate portfolio the highest marks. Their assessment describes the investments this way: "The AMHTA has a high quality, well leased, well managed portfolio. " They further state that the portfolio is "top performing" and is producing results well above their own benchmark as well as the APFC. Finally, their evaluation concludes that the REMP is achieving "**Outstanding** Portfolio Performance."

When the Trustees began to discuss commercial real estate as an option for investing trust principal, one of their goals was to attenuate risk. After the recession that hit in 2008, and the lower earnings from the Trust Fund, they began to consider options for flattening the swings associated with the stock market. They also talked about what would happen if the state encountered a prolonged economic downturn. Fluctuating resource values were also a concern as they watched gold prices hit $1,773/oz. in June of 2012 and then fall to $1,200 nine months later. Consistent income and protected asset values were needed to meet the program needs of the beneficiaries and reduce the risk that was impacting the Trust at the time.

After almost a decade of successful implementation of the REMP the results have been impressive. Now, the Trust finds itself faced with not one of the contingent major risk factors, but all three. The returns to the APFC managed Trust Fund from the stock market are likely to be severely impacted by the national recession caused by the current pandemic. The State of Alaska is entering what is predicted to be an extended economic downturn. Oil prices and timber prices are severely depressed. The good news is that gold is back up to the prices of 10 years ago. More important, however, is the fact that the real estate investments that are held by the Trust are performing well and are producing low risk returns that are consistently above the returns reported by the APFC for the Trust Fund. The IRS, the States of Washington and Texas and the Fortune 500 companies that occupy space in these Trust owned buildings are continuing to pay their rent and will continue to do so. Chart # 1 also demonstrates this. Little did the TLO think that they needed to plan for multiple concurrent challenges to their investment strategies, but that is exactly what happened. And the REMP is performing as it should.

Why Debt?

It is common for real estate investors to acquire debt against income properties. Such debt is often referred to as "leverage". A detailed and somewhat technical discussion of the power of leverage is attached. This information was shared with the Trustees as they evaluated the REMP in 2012/2013. The purpose of leverage, in the form of debt, is simply to share risk with the lender while increasing the investor's return on their investment. The risk is shared by the lender investing in the real estate in return for a fixed low risk cash flow return - interest. The investor's cash investment is reduced by the amount of the debt; however, the market lease rate is based on the value of the property, regardless of debt. If the interest rate is lower than the lease rate of return, then the investor increases their return by the difference.

For instance, an investor buys a fully leased property for $1,000,000. The local market for rent on this type of property is based on 8% of the property's value. In this case that would be $80,000 per year in rental income. A lender provides interest only debt of $400,000, leaving the investor with a $600,000 investment. The interest on the loan is 4%, or $16,000 per year. After the interest payment, the investor keeps $64,000 per year as income. On the $600,000 investment, that amounts to a $10.7% return and it frees up $400,000 for additional investment. Of course, the prudent investor would keep a reserve fund available for repayment of the loan.

Why Not Interest Only Debt?

A variation of this approach involves acquiring amortized debt. With amortized debt, the investor splits the rental income between scheduled debt reduction payments and interest payments to the lender over the life of the loan. Thus, the investor's return comes back in the form of returned principal (equity as a result of debt repayment) and income. In the example above, the $64,000 in cash flow is in the form of returned principal and income.

The Trust chose the latter approach to apply to the properties acquired through its REMP. The interest only approach may be more desirable to investors, both private and public entities, who intend to be long term investors and who want to utilize cash reserves on a more permanent basis. However, the Trust, through the TLO, has the obligation to ultimately deposit funds derived from the sale of principal assets in to the Trust Fund. By acquiring amortized debt, that is exactly what would happen.

The rational behind this approach was this. The Trust would establish a target allocation of their total asset portfolio that would be invested in commercial real estate. Let's assume that the goal was to achieve a 20% allocation or $100,000,000. An initial investment is made using $40,000,000 from the TADA and using $40,000,000 in amortized debt, yielding a 50% loan to value ratio, which purchases $80,000,000 in real estate. When that debt is paid off, the Trustees would then be able to use 100% of the rental income to acquire additional real estate if needed to get to their desired allocation. If the allocation had already be achieved, then that portion of the lease income could be used to deposit the $40,000,000 in acquisition principal to the Trust Fund. The principal eventually gets to where it is supposed to go and the Trust's equity in the commercial real estate is forever treated as income. Thus, it can be used to maintain and build the Trust's portfolio and to maintain its desired allocation as the rest of the portfolio grows.

The requirement to assure that all cash generated from the sale of Trust assets end up in the separately managed Trust Fund is fairly unique in the investment world but probably makes sense considering the Trust's history, mission and asset base. Until changes are made to the appropriate Alaska Statutes, that requirement will remain. Amortized debt is the tool that allows the Trust to invest principal into income property and subsequently return the invested principal to the Trust Fund while simultaneously generating income to fund Trust programs.