Trust
Alaska Mental Health
Trust Authority

3745 Community Park Loop, Suite 200
Anchorage, AK 99508
Tel 907.269.7960
www.mhtrust.org

MEETING AGENDA

Meeting:	Finance Committee
Date:	September 16, 2020
Time:	9:00 AM
Location:	online via webinar and teleconference
Teleconference:	(844) 740-1264 / Meeting Number: 133 201 3441 # / Attendee Number: # https://alaskamentalhealthtrust.org/
Trustees:	Laraine Derr (Chair), Verné Boerner, Rhonda Boyles, Chris Cooke, Anita Halterman, Ken McCarty, John Sturgeon

Wednesday, September 16, 2020

		Page No.
9:00	**Call Meeting to Order (Laraine Derr, Chair)** Roll Call Announcements Approve Agenda Ethics Disclosure	
9:05	**Planning Item** Commercial Real Estate Portfolio Next Steps • Mike Abbott, CEO • Carol Howarth, CFO • Wyn Menefee, Executive Director TLO	4
12:00	**Adjourn**	

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Future Meeting Dates

Full Board of Trustee / Program & Planning / Resource Management / Audit & Risk / Finance

(Updated – September 2020)

• Audit & Risk Committee (tentative)	October 21, 2020	(Wed)
• Finance Committee (tentative)	October 21, 2020	(Wed)
• Resource Mgt Committee (tentative)	October 21, 2020	(Wed)
• Program & Planning Committee (tentative)	October 22, 2020	(Thu)
• Full Board of Trustee	November 18-19, 2020	(Wed, Thu) - Anchorage
• Audit & Risk Committee	January 6, **2021**	(Wed)
• Finance Committee	January 6, **2021**	(Wed)
• Resource Mgt Committee	January 6, **2021**	(Wed)
• Program & Planning Committee	January 6, **2021**	(Wed)
• Full Board of Trustee	January 27-28, **2021**	(Wed, Thu) – Juneau
• Audit & Risk Committee	April 21, **2021**	(Wed)
• Finance Committee	April 21, **2021**	(Wed)
• Resource Mgt Committee	April 21, **2021**	(Wed)
• Program & Planning Committee	April 21, **2021**	(Wed)
• Full Board of Trustee	May 26, **2021**	(Wed) – TBD
• Program & Planning Committee	July 27-28, **2021**	(Tue, Wed)
• Audit & Risk Committee	July 29, **2021**	(Thu)
• Resource Mgt Committee	July 29, **2021**	(Thu)
• Finance Committee	July 29, **2021**	(Thu)
• Full Board of Trustee	August 25-26, **2021**	(Wed, Thu) – Anchorage
• Full Board of Trustee	November 17-18, **2021**	(Wed, Thu) – Anchorage

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Future Meeting Dates

Statutory Advisory Boards

(Updated – September 2020)

Alaska Mental Health Board / Advisory Board on Alcoholism and Drug Abuse

- Executive Committee – monthly via teleconference (Second Wednesday of the Month)
- October 8-9, 2020 – Board Meeting / Webinar

Governor's Council on Disabilities and Special Education

- September 29-30, 2020 – Anchorage/ZOOM
  (possible pre/post-meeting for Autism Ad Hoc and/or Workgroup on FASD)
- February 2021 Juneau/ZOOM

Alaska Commission on Aging

- September 22-23, 2020 – Quarterly Meeting / Webinar

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To: Laraine Derr, Finance Committee Chair
From: Mike Abbott, Chief Executive Officer
Date: September 9, 2020
Re: Commercial Real Estate Portfolio

REQUESTED MOTION:

The Finance Committee recommends the Board of Trustees authorize the CFO to refinance as much of the current CRE debt as is prudent in order to reduce debt service requirements and maintain flexibility to allow for future property sales. The CFO may use interest-only debt that allows the Trust to pay down the loan.

Background

The Trust currently owns seven commercial real estate investment properties. All properties except for Cordova are financed with individual mortgages. Two properties, San Pedro (North Park) and Ridgepoint (Promontory Point) are financed with balloon payments due FY22 and FY26, respectively. The remaining mortgage lives are 10 years for Israel, 14 years for Rulon and Commercial, and 17 years for Amberglen. All six mortgages require some level of amortization. Below is a summary by property of the recent fair market appraisal valuations, debt summary, and leasing status.

$MM

	Cordova (2011)	Commercial (2013)	Rulon (2013)
	(TLO)	*(Cummins)*	*(IRS)*
Current Value:	$4.100	$2.870	$20.100
Debt:	$0	$1.010	$6.556
Rate:		3.94%	4.20%
Prepay Penalty:		None	None
	100% occupied, includes TLO	*100% occupied with anticipated lease renewal*	*100% occupied with long-term, strong-credit, single-tenant lease*

	Israel (2014)	Ridgepoint (2015)	San Pedro (2015)	Amber Glen (2016)
	(WA)	*(Promontory Point, TX-DOT)*	*(North Park, Marriott)*	*(Amber Oaks, Xerox)*
Current Value:	$18.860	$15.500	$13.500	$27.644
Debt:	$6.809	$9.408	$6.628	$11.592
Rate:	4.35%	4.69%	5.20%	4.25%
Prepay Penalty:	$0.506	$1.158	$0.197	$1.573
	WA purchase option at 98% of appraisal. Current lease negotiations expected to set a reference rate for 2023	*100% occupied. DOT backfilling upcoming vacancy*	*Active leasing showings to fill vacancies, including potential October vacancy*	*Active leasing*

Performance is expressed through a) net earnings distributed from the individual LLCs to the Trust, providing ongoing revenue for Trust beneficiary benefit, and b) growth in equity through amortization of debt and property appreciation, monetized when a property is sold and the proceeds are invested for the benefit of beneficiaries in perpetuity.

Actual income distributed to the Trust from the combined properties has been significantly lower than predicted at the time of Trustee purchase approval, and slightly lower than management expectations since then.

Expectations for property value growth was not explicitly predicted at the time of Trustee approval of purchases. Year-end FY20 appraisals and broker's opinions demonstrate portfolio total value of $102.6m combined asset value, up $1.6m from the prior year. With $42m total mortgage debt outstanding, the Trust's equity at YE FY20 Fair Market Value is $60.6m, 1.5 times the $39m invested between 2011 and 2016. Approximately $9m of the equity growth is from debt amortization, and $3m is a result of property appreciation.

Options

At the July 2020 Finance Committee, the Trustees examined several options for near-term management of the seven properties. Based on feedback from Trustees at that meeting, staff has further refined the options and added one for consideration.
The options examined here are: 1) Hold Properties – Use Cash for Balloon Payments, 2) Hold Properties – Refinance, 3) Liquidate Properties and Invest Proceeds with APFC/DOR, and 4) Sell 2-3 Properties – Hold the Remainder.

<u>Hold Properties – Use Cash for Balloon Payments</u>

Under this approach, the Trust would plan to maintain ownership of all seven properties for at least three years and maintain the existing, amortizing loans for the six leveraged properties. The existing loans for two of the properties require balloon payments in 2021 and 2025. In those years, the rest of the properties will not generate enough funds to fund the balloons. Cash from Trust reserves would be the likely source of the necessary investment -- $6.3m in 2021 and $8.4m in 2025. The primary objective of Trust reserves is to provide resources in the event other Trust revenues declined sharply for several years. Using reserves to invest in investment properties would make them illiquid until the properties were sold or refinanced and unavailable for the core function of Trust reserves. The result of those investments and the continuing amortization of the other loans would increase earnings from the portfolio, but reduce investment income by $625k (because $14.7m of Trust reserves would be withdrawn from APFC/DOR investments and invested in real estate).

The present value of future cash distributions (PV) for this approach is essentially the same as the *Hold Properties – Refinance* option. Additionally, the possibility of smaller earnings and/or less asset growth is greater than other options.

The increased investment in the properties increases the Trust's exposure to downside risk associated with poor asset performance as a result of local market conditions, national or regional economic conditions, changes in office building utilization, etc.

This approach rapidly increases the equity in the properties.

<u>Hold Properties – Refinance</u>

Under this approach, the Trust would plan to maintain ownership of all seven properties for at least three years and refinance as many of the six existing loans as possible (some of the loans have pre-payment penalties or restrictions) by consolidating new debt into a single interest-only loan. By refinancing with a lower interest rate than the existing loans, and reducing the debt service obligation to interest only, cash for beneficiary use is increased an estimated $1.5m per year. The new loan could have options for the Trust to payoff portions of the loan if individual properties were sold. As an interest-only loan, there would be a large balloon at the of the loan term that would require refinancing or sale of assets.

The PV is essentially tied with the *Hold Properties – Use Cash for Balloon Payments* option. The use of interest-only debt will reduce the rate of growth in equity in the properties. Although growth in asset equity is positive, growth in value of an illiquid asset offsets some of the benefits.

Liquidate Properties and Invest Proceeds in APFC/DOR

This approach assumes sale of all seven properties in the next three years and then depositing sale proceeds in Trust accounts at APFC and/or DOR.
The distributions from this approach will ultimately be higher than recent distributions from the real estate investments, but lower than the likely distributions from other approaches. As such, this approach generates the lowest PV of the options considered. Typically, this approach would also yield significantly less volatility than the other approaches. However, the current investment market condition is significantly more dynamic than usual. So lower volatility is likely, but not assured.

Liquidate 2-3 Properties, Invest the Proceeds in APFC/DOR, Hold Remaining 4-5 Properties

There are two different objectives that could be satisfied by this hybrid approach. This approach could be the initial steps in a strategy to sell all of the assets over 5-10 years, selling when properties were at or near their anticipated peak value. Or it could be used to eliminate the poorest performing assets among the seven properties and holding the remainder. The choices of which properties to sell vary between the two longer term objectives. We have done preliminary evaluations of both approaches.

Since we didn't know which of the two alternate strategies this approach would favor, we also didn't know the answers to key questions necessary to do a full evaluation. As a result we can't reliably anticipate the specific sell/hold outcomes. It is not useful to develop an "expected case" for this approach since we don't know enough about how it would be implemented. Instead we have presented the high and low estimates. If Trustees wish to examine this further, we would need to answer several questions to get started like: Which properties to sell and what sort of debt to use for the retained properties?

Comparisons

We have provided a basis of comparison of the four approaches.

The primary metric for determining the relative value of each approach is net present value. This is the most commonly used financial tool to measure the relative values of different investment options. In the following table, the PVs of each approach is provided.

PRESENT VALUE OF EXPECTED FUTURE DISTRIBUTIONS				
	Status-Quo	Status Quo	Liquidate Properties	Liquidate 2-3 Properties
	Use Cash for Balloon Payments	Refinance	Invest Proceeds in APFC	Invest Proceeds in APFC
Expected	**$138.0m**	**$137.5m**	**$63.0m**	
High	*$205.8m*	*$227.9m*	*$96.1m*	
Low	*$90.6m*	*$105.6m*	*$38.3m*	
Example - Rulon & Commercial				
High				*$258.8m*
Low				*$73.1m*
Example - Israel & San Pedro				
High				*$191.8m*
Low				*$47.4m*

The next most important metric is the distributions from the investments. After all, the Trust doesn't hold investments for their own sake. Our invested assets are important because they generate revenue necessary to serve Trust beneficiaries. Here are the estimates for the distributions of each approach's expected case.

EXPECTED ANNUAL DISTRIBUTIONS					
	Status-Quo	Status Quo	Liquidate Properties	Liquidate 2-3 Properties / Invest Proceeds in APFC	
	Use Cash for Balloon Payments	Refinance	Invest Proceeds in APFC	Ex: Rulon & Commercial	Ex: Israel & San Pedro
FY21	$1,280,786	$3,404,795	$1,280,786	$1,280,786	$1,280,786
FY22	($3,390,121)	$4,634,652	$2,884,169	($4,145,869)	($4,177,707)
FY23	$6,014,789	$7,537,726	$652,931	$5,053,483	$3,886,958
FY24	$3,955,893	$5,478,831	$1,394,008	$3,083,942	$3,597,104
FY25	($2,278,926)	$7,623,283	$2,209,938	($3,588,691)	($4,211,106)
FY26	$3,541,533	$4,428,529	$3,082,235	$2,214,386	$3,849,429
Total, 6-yr	$9,123,953	$33,107,815	$11,504,067	$3,898,036	$4,225,464
Nominal, Illustrative purpose only					

Guidance from Harvest Capital

In 2019 the Trustees amended the Trust's Asset Management Policy Statement to include a requirement that the Trust gain external expertise related to its real estate investments. In October, 2019 Harvest Capital was selected through a competitive process to support the Trust. Harvest is an SEC-registered consulting firm advising pension funds, endowments, private capital and institutional investors on their real estate investment portfolios.

Harvest Capital recommends that the properties be held for the time being and refinanced using a single interest-only portfolio loan to take advantage of lower market interest rates and the ability to manage cash flow at the portfolio level. One of the biggest advantages is payment flexibility—one could pay down the loan principal like an amortized loan, or use the interest-only structure to manage cash requirements of the properties.

Conclusion

We recommend the Trust maintain ownership of the seven properties (notwithstanding the options to sell Israel and Prom Point as allowed in their current leases). Further, I recommend that the CFO be authorized to refinance as many of the properties as possible using an interest-only portfolio-based instrument designed to maintain flexibility regarding future sales and/or refinancing, but not necessarily to reduce loan principle. This basis for this recommendation is:

1. The present value of this strategy is one of the two highest options being considered. This provides the best balance of income for immediate use, asset value growth over time and limited risk.
2. Although liquidation (and re-investment of proceeds in the Trust Fund or reserves) may be the appropriate course of action eventually, the near-term markets for most of the seven properties are too uncertain at this time. Although the values for nearly all of the properties are relatively high, it is not likely that the Trust will recognize those values in sales in the next 1-2 years due to market uncertainty related to Covid-19 and unknown office utilization expectations.
3. The opportunity for lower interest rates, necessary flexibility and near/medium-term income generation make portfolio-level debt the most attractive option at this time. The debt instrument(s) can be structured to allow defeasing a proportional share of the debt if or when a property is sold. A term of 7-12 years can be negotiated. At the end of the term, if not sooner, the properties can be refinanced. Additionally, the loan principal can be paid down during the loan term.
4. Harvest has advised the Trust that this is the best course of action due to the lower cost and greater management flexibility. They describe this as the best practice for owned real estate assets.
5. Although maintenance of Trust ownership of these investments may cause concerns among key external stakeholders, it is consistent with the Trust's commitments in response to the 2018 legislative audit:
   - No further principal-funded real estate investments
   - Trust decisions are guided by external expertise as required by our updated Asset Management Policy Statement
   - The Mental Health Trust Fund has been "made whole" by transferring Trust reserves in an amount equal to the amount of funds invested in commercial real estate.
6. This approach does not add any further Trust income to the commercial real estate to enhance equity. Using existing liquid Trust reserves and investing them in the commercial real estate might enhance returns in 5-10 years, but it would take resources that could be used for beneficiaries in the near-term and put them in an ill-liquid condition for many years.
7. Like several other options, unsolicited purchase offers or leases with purchase options would be entertained and recommended if the terms were favorable to the Trust.