



STATE BOARD OF LAND COMMISSIONERS

Philip E. Batt, Governor and President of the Board
Pete T. Cenarrusa, Secretary of State
Alan G. Lance, Attorney General
J. D. Williams, State Controller
Anne C. Fox, Superintendent of Public Instruction

Stanley F. Hamilton, Secretary to the Board

TRANSCRIPT: Cottage site rents - sidebar to Evergreen Land Exchange
Regular Land Board Meeting
July 29, 1996

This portion of the transcript was from the regular meeting of the Idaho State Board of Land Commissioners held on July 29, 1996 in replacement of their usual August meeting. Those participating in the discussion included:

Governor Philip E. Batt, presiding
Secretary of State Pete T. Cenarrusa
Attorney General Alan G. Lance
Controller J. D. Williams
Superintendent of Public Instruction Anne C. Fox
Director Stanley F. Hamilton, Secretary to the Board
Perry Whittaker, Real Estate Bureau Chief

Doug Dorn, Chairman of Dorn & Hellieson & Cottle Consulting
Robert Maynard, Chief Financial Officer for PERSI
Mike Ferguson, Chief Economist for Division of Financial Management

John Evans, Evans Brothers Construction

ATTORNEY GENERAL LANCE. Governor, with your permission, I'd like to ask a couple of questions of the panel but, just to make sure that I'm reading you all correctly and understanding that an investment at 7% is not one of the options that I think this board would pursue - what I believe each of you is telling is us that to fulfill our obligation to maximize the return to the endowment fund to fulfill our fiduciary obligation, the swap as proposed, assuming the appraisals come back in substantially as the appraisals previously done would be the best way to fulfill our fiduciary obligation.

We have two yeses, and something different.

ROBERT MAYNARD. Yes, and the reasons are primarily, Governor and Mr. Lance, are primarily from my perspective (1) you have a lot more options with timber lands, they're a lot more liquid, and your management staff is a lot more professional with that. For example, if they wanted to swap back into income-producing commercial real estate property, they could probably do that swap without having to go to the endowment board. Also, to... well.

ATTORNEY GENERAL LANCE. Doug it was my impression that you agree with that assessment?

DOUG DORN. Yes, that's correct.

ATTORNEY GENERAL LANCE. And Mike, it's my understanding you do not agree?

MIKE FERGUSON. Gentlemen, Mr. Attorney General, I do not. I agree with pretty much everything that you've heard with the exception that the conclusion from this information is that you should go forward with this swap. I think the information that you've been provided that its probably not a good idea to invest in cottage land is a sound recommendation. I think the reason for that is because policy issues and perhaps market conditions - it is a suboptimal investment. Some of the value in vacation type property is an amenity value and it is difficult to achieve that, to realize that, in terms of an income stream if you do not own that land. There may, in fact, be a gap between what the market prices the property as a value, which is a paper value, and what you may be able to realize from sale and what you can realize through annual rentals for leases of that property. We haven't tested that, we don't know what the answer is. What we do know, however, is the current yields in terms of income streams is suboptimal. And to point that out - let me point out on the analysis that was reviewed by Don Reading - on page four, alternative two, if you look at the cottage scenarios, annual income stream is \$11,800 and that stream is increased over time at a 5.3% rate first and 10% rate after 2003. What you have is an asset worth a million and a half generating an annual income stream of \$11,800.

GOVERNOR BATT. Less than 1%.

MIKE FERGUSON. Less than 1%.

Now, when you do the discounting of this, you get a value in a net present value because there is a residual value to the land - you've inflated it at 6%. But, if you were to continue after 30 years, holding this land and continuing this current practice or if you go to alternative two (which is more favorable from an income standpoint) it assumes that you immediately go to 2.5% and hold there...

GOVERNOR BATT. I thought you were talking about two on page four.

MIKE FERGUSON. I'm sorry, I mis-spoke. If you go to alternative one, which suggests that you go to 2.5% immediately and run it out in perpetuity, you would still be at about three quarters of a million dollars because 2.5% is not a very good return on an asset worth a million and half dollars. This is the equivalent to going out and renting commercial property, say worth \$100,000 and getting an annual rent of \$2,500. It doesn't wash. And, we've discussed this among ourselves and the likely kind of return we'd get on a real asset if you were dealing with an arm's length, impassionate, business oriented environment, is probably more like 10% and you'd probably see the annual income stream significantly higher.

GOVERNOR BATT. Of course, the difference between that and the cottages is that the cottages have historically gone up astronomically in value whereas commercial would not.

MIKE FERGUSON. Mr. Chair, I suppose that would depend on where the commercial property is located and how that fits in...

GOVERNOR BATT. Highly unlikely. Couldn't.

MIKE FERGUSON. I would point out that if your value's going up substantially, and your under-achieving your return because of submarket rental rates, then you're not realizing the benefit. The real benefit that's coming out of this is the annual income stream that is going to public schools and that's what needs to be focused on.

The thing that disturbs me in this is if you look at alternative one, which is an unrealistic scenario for the cottages, it actually comes out ahead of the timber land alternative. Now, that's looking at an income stream based on annual rentals from cottage sites and the harvest yields converted in dollars and discounted over this analysis period for the timber land. I agree with these gentlemen that the prescription is most likely that you should divest yourselves of the cottage land and put in a more suitable income generating asset, whether that be real property, financial investments - I think that's an open question and there was some good starting discussion of that.

What I don't conclude from this is that the swap is a good deal. There are questions in my mind that are not answered and one of them is we know that the cottage alternative is suboptimal, even at 2.5% and yet it comes out ahead of the timber option. I'm not comfortable with that making good sense then to do the swap.

ROBERT MAYNARD. Governor and members of the board. I understand where Mike's coming from on that. I would only make three points.

First, that again, the premise from which I'm operating and Doug's operating is that we're assuming the appraisals reflect current third party market values which is the charge of the appraisers. And, by the end of this you'll have four - at the end of this - and whether or not - you can always quibble with appraisals - that's not my job - with real estate you can quibble with appraisals; generically, we're talking about within the realm of reason.

Secondly, I agree with Mike. The fact of the matter is that - and to me I think I draw a different conclusion from it. The cottage rentals - why we run numbers on cottage rental property - I would up the current yield and decrease the depreciation on it. It's very, very difficult for any piece of property over a 30 year period or longer to increase much above inflation. While you may have 10 or 15 years where it catches up, over the long term, inflation is generically when you tend to draw the appreciation component of a piece of real estate and you look at yield to make up the difference. So, for a private, still liquid, real estate investment, you need to get about an 11% return. That's the number I use for our real estate to determine whether to sell it or keep it or whatever. That means that your inflation number, before you need a current yield, is about 6-7% of market value to make it

worth your while and you haven't been getting that off your rental property. To me, that reflects the fact - and this is not just this board, it has been the consistent history of all boards back to the beginning of whenever you had this - that indicates to me that there is going to be a consistent management problem with the cottage sites in getting full market value. I don't necessarily care who is the board or what, it just seems to me, that the history - until it is proven to me otherwise - I would say this just underlines the management problems that this sort of organization will have with this sort of property and that indicates to me that I would rather have some place else where those management problems are less, like timber land.

Third, is again, if you were running numbers, the big number I would have a big problem with and this - I would like to see what happens if you drop that 6 down to 4 or 5 and then give a more consistent yield number. Like Doug said early on, you can run numbers from here to beyond, but to me the big lesson I have out of these numbers is that this is a big, management and administrative problem for which you are not being properly compensated. I would say, that is one of those specific, practical problems - forget liquidity, forget current market value, that alone I would simply because of historical problems - move on to something else.

GOVERNOR BATT. Doug.

DOUG DORN. In looking at this, also, it would seem to me that there is a threshold of pain by which those lessees are unwilling to pay rent. We don't know what that is but a 500% increase from here, seems to me that it's getting pretty touchy. Even with that, even if you got a 500% increase, it's still a marginal investment. What you're doing is speculating raw land over a long period of time. That's what it is. And that doesn't -

GOVERNOR BATT. I can tell you what you say is very real. We're already getting a lot of protest, particularly from the Priest Lake area and how they might be affected by all this. It's hard to raise 'em. No kiddin'.

ATTORNEY GENERAL LANCE. I think as Mr. Maynard said, you I think you hit the bit and move on, sir.

GOVERNOR BATT. Further questions, comments.

ATTORNEY GENERAL LANCE. A comment sir, and possibly in the form of a question to Stan. Stan, have we factored into the numbers relative to the stumpage, the probability of a decreasing timber supply throughout the United States as a result of action by the Forest Service?

DIRECTOR HAMILTON. Our number that we used for appreciation and stumpage prices, the 6.6%, is based on 30 some years of experience that we've had, so we did not try to project that forward. Interestingly enough, we also did not try to incorporate a huge spike in timber prices that occurred over the last three years. When they went up like this and then

crashed right back down so that their almost on a very smooth line that continues from 30 years ago. So, we didn't incorporate that at all. We elected to be fairly conservative about those numbers and rely on numbers that we were pretty confident of.

ATTORNEY GENERAL LANCE. Just an observation, Mr. Governor and members of the board, I had a meeting with Mr. Jack Ward Thomas of the United States Forest Service I believe in March and it's inevitable that there's going to be less harvestable timber on federal lands in the next few years than has historically been the case. It would seem to me that would impact in this equation in terms of state timber will be more valuable than less valuable.

DIRECTOR HAMILTON. Governor, Mr. Attorney General. We used a stumpage figure here of about \$250 a thousand. A few years ago that probably would have been \$350 a thousand or more. What you're saying is a very real thing and we did not factor it in other than as an extension of what has occurred over the long term.

ATTORNEY GENERAL LANCE. The other observation, Governor, members of the board, is that these are gross figures, not net figures and any of those of us on the board who are in the investment business personally or otherwise, figure what it's going to cost to manage the investment. So, if you're managing a bunch of small parcels versus one large parcel, chances are you're going to have more cost in management of some of the problem parcels and potential vacancy factors as well.

GOVERNOR BATT. That's correct and our experts have already pointed out the inordinate amount of time that we spend, this board, and our staff, on these cottage sites.

DIRECTOR HAMILTON. A couple of things I would add, Governor. First of all, we have commissioned the new appraisals or the re-appraisals and we had hoped to have some preliminary figures but we have not been able to get them at this point. So, we do not have appraisal figures. We wanted this information now because you will not meet again until mid September and I don't know when the appraisals will be back, but I think they're scheduled for sometime around the first, the 10th of August, is that not right [to staff].

PERRY WHITTAKER. Governor, members of the board, Stan. Appraisals should be done by the end of August.

DIRECTOR HAMILTON. End of August, okay.

GOVERNOR BATT. Tenth of August?

DIRECTOR HAMILTON. The end of August.

GOVERNOR BATT. End of August.

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ATTORNEY GENERAL LANCE. Governor and Stan, any action of this board necessary to get those appraisals to these individuals? Do we have to approve that?

DIRECTOR HAMILTON. No. No.

The other thing that I would add, in accordance with the Governor's suggestion that we take a look at this on a long term basis is, we have visited with Mr. Reading and these gentlemen and they are interested in working with us over about the next year in an attempt to analyze the portfolio of lands that we have. We can certainly set up a joint session with the Investment Board and the land board if that would be your pleasure. We would taking a look at the lands that we currently have in our portfolio, what they're doing performance wise and what we might want to do to have a well-balanced portfolio.

GOVERNOR BATT. I'm just kind of mulling over in my own mind, maybe we ought to formalize that and have a couple legislators involved - J.D. and some of the folks from the Endowment Investment, PERSI, try to develop an overall state policy for investment.

CONTROLLER WILLIAMS. That's a good idea.

GOVERNOR BATT. We'll give that some consideration.

DIRECTOR HAMILTON. I think unless these folks have anything additional, that's what we would have. I don't think you're ready to make a decision until those new appraisals are complete.

GOVERNOR BATT. Certainly appreciate your help.

CONTROLLER WILLIAMS. Very interesting.

GOVERNOR BATT. We can't pay you much, but we can listen.

BOB MAYNARD. Always a pleasure dealing with someone else's problem for which you have no responsibility.

GOVERNOR BATT. Thanks.

ATTORNEY GENERAL LANCE. Thank you.

GOVERNOR BATT. Once again, in keeping with our determination when we first talked about this or last talked about this, we want to proceed in as rapid a fashion as possible. Is that correct? So, when we get these appraisals, we'd better act on them. Is that still our desire?

DIRECTOR HAMILTON. That's true, Governor, that is.

CONTROLLER WILLIAMS. I believe so.

SUPERINTENDENT FOX. What about a conference call? Would they come in and do a board meeting like that to deal with this issue because they didn't really give us a time frame.

GOVERNOR BATT. Whatever. Works for me.

DIRECTOR HAMILTON. We could certainly do that. That certainly is a possibility. A dual conference call. Those that are in town could meet in one place and those that are not would be able to call in. We certainly will try to set that up.

GOVERNOR BATT. Okay, we're looking at item number 13.

DIRECTOR HAMILTON. Governor, this is an approval on a settlement agreement between the state, Idaho Forest Industries and Evans Brothers Construction. Steve Schuster, our counsel, is here to present that and has with him Steve Thomas. Steve I would turn that over to you.

JOHN EVANS. John Evans of Evans Brothers Construction.

GOVERNOR BATT. Before we leave that other subject, are we going to face up to the problem of where we want these cottage rentals this year?

J.D. you can talk about that.

CONTROLLER WILLIAMS. Governor, I don't know if the time is right to make a motion, but I - it's become apparent I think at looking at this study and the two alternatives that were presented to us that policy that was adopted in, well about 1991 or 1992 has accomplished what we wanted it to do and that was to try to stabilize private land values to see what these lots were actually worth. There is a question now about whether we're getting the return, even a minimal return necessary. And I would ask - in fact, I'd make a motion to ask our staff to review the cottage site lease rate program and come back to us within a month or two with a proposal to increase them.

GOVERNOR BATT. Would you mind holding that a little. We'll take a five minute break. I didn't realize we'd gone so long.

CONTROLLER WILLIAMS. Okay.

GOVERNOR BATT. Al, I think, has a nicotine problem. So, if its alright with you folks we'll take a little break.

[upon return from break].

J.D.'d made a motion when I noticed the Attorney General wasn't present, so.,,

ATTORNEY GENERAL LANCE. Well, Governor, it's been reported to me that you reported the reason for my absence which I'd like to correct - it was hydraulic as well as the...which I'd like the record corrected.

GOVERNOR BATT. So noted.

Well, J.D. you had the floor.

CONTROLLER WILLIAMS. Yes, Governor, in view of this study, I think we've shown a couple things: first, that one of the reasons that we did the present cottage site lease program was to try to stabilize private land values, to take some of the pressure off private land values that seemed to be making them artificially high so that we could get a real feel what they were worth because they were the comparables we used to determine our lease rates. It's been over four years now since we've done that and it looks like we've accomplished that and the study has indicated that we're below market and there is some fiduciary responsibility, so I would ask - make a motion - that our staff review the present cottage site lease program and come forward with some recommendations to us and make the review in conjunction, possibly, with some of the economists that were with us today who I think did an excellent job of explaining it and come up with a new program for the state and return as soon as possible with that - hopefully, like in November. Is that realistic?

DIRECTOR HAMILTON. Yes.

CONTROLLER WILLIAMS. Of this year.

SECRETARY CENARRUSA. As much as I'm the other hold over, I would second this and in view of the very intelligent presentation that we had today, I think I've learned a lot and in view of that, I would second this.

GOVERNOR BATT. Discussion.

Anne.

SUPERINTENDENT FOX. Mr. Chairman, I don't know if that's going to give us enough time. I might encourage that we begin by October because we have six months by law to raise the rates and they have to give them notice. By my calculation, that would be January/February up to June and knowing us with our conversations, it may take us two board meetings to get through that issue.

DIRECTOR HAMILTON. Governor, typically rentals change the first of the year, January first. So, I think if you took an action in November or December or even January then that would provide us with plenty of opportunity to get the notice out and the rents would not occur until the following year.

SUPERINTENDENT FOX. So, is that two years?

DIRECTOR HAMILTON. No. Our leases run from January through December rather than July first through June.

GOVERNOR BATT. You mean there's no way we can increase them for next year?

DIRECTOR HAMILTON. Well, you could but you have to provide at least six months written notice, so you'd have to change them in the middle of the year to do that.

GOVERNOR BATT. Alright. So there's no real urgency. Does that satisfy you Anne?

Okay, you've heard the motion, all in favor will indicate by saying aye, opposed nay. The ayes, have it. Chair votes aye. The motion passed unanimously.