

STATE BOARD OF LAND COMMISSIONERS
August 18, 2015
Regular Agenda

SUBJECT

Approve:

- Distributions to endowment beneficiaries for fiscal year 2017
- Transfers from Earnings Reserve

BACKGROUND

By statute, the Land Board determines the allocation of the Earnings Reserve Funds of the endowments – how much to distribute to beneficiaries, how much to transfer to the permanent fund, and how much to retain for future distributions. The Land Board's Asset Management Plan requires the Endowment Fund Investment Board to provide a recommendation on this allocation based on the Land Board's Distribution Policy.

Land Board approval of expected distributions in August allows beneficiaries to reflect these in their budget submissions due September 1.

DISCUSSION

As detailed in the table below, the Endowment Fund Investment Board recommends the Land Board approve an 11.8% increase in total distributions for fiscal year 2017 compared to fiscal year 2016. Distributions would increase for all endowments except State Hospital, to reflect lower forecasted land income and increased exposure to fund volatility due to cabin site sales.

In addition, the Investment Board recommends that \$39.5 million of Earnings Reserves for six endowments be transferred to their Permanent Funds effective September 1, since these endowments have more than the target level in their reserves. Further, it is recommended that all of the transfers increase the Gain Benchmarks (or permanent corpus) of those funds, since all six have already achieved their previous Gain Benchmarks.

As explained in Attachment 1, the recommended distributions and transfers appear to be achievable and represent an appropriate balance between the interests of current and future beneficiaries, taking into account the current level of earnings reserves and expected future fund returns and land revenues.

Table 1

	<i>Distributions To Beneficiaries</i>				<i>Transfer To Permanent Fund**</i>	<i>Added to Gain Bench- mark***</i>
	<i>Approved FY2016</i>	<i>Proposed FY2017*</i>	<i>% Change</i>	<i>\$ Change</i>		
Public School	32,758,800	36,724,800	12.1%	3,966,000	-	-
Ag College	1,288,800	1,347,600	4.6%	58,800	935,000	935,000
Charitable Instit.	4,500,000	5,544,000	23.2%	1,044,000	18,329,000	18,329,000
Normal School	3,608,400	4,262,400	18.1%	654,000	10,850,000	10,850,000
Penitentiary	1,872,000	1,965,600	5.0%	93,600	1,449,000	1,449,000
School of Science	3,866,400	4,708,800	21.8%	842,400	7,763,000	7,763,000
State Hosp. South	4,562,400	4,562,400	0.0%	-	-	-
University	4,016,400	4,042,800	0.7%	26,400	209,000	209,000
	<u>56,473,200</u>	<u>63,158,400</u>	<u>11.8%</u>	<u>6,685,200</u>	<u>39,535,000</u>	<u>39,535,000</u>

* Based on 5% or 7% of 3-year average Permanent Fund balance, adjusted for transfers from Earnings Reserve and deposits from the sale of cabin sites for Normal School. State Hospital distributions held at previous year's level, to reflect forecast of low land income and increased earnings volatility. Public School distributions limited to one-fifth of the current reserve balance.

** Amount of Earnings Reserve in excess of what is deemed adequate relative to the 2017 distribution.

*** Amount of each transfer that will be considered a permanent increase in original corpus. Since there are no past losses and inflation has been offset, this year all transfers add to the Gain Benchmark.

All calculations subject to adjustment pending final audit of fiscal year 2015 results.

RECOMMENDATION

Approve the recommended distributions totaling \$63.2 million and transfers totaling \$39.5 million.

BOARD ACTION

ATTACHMENT

1. Proposed Fiscal Year 2017 Distributions and Transfers

Proposed Fiscal Year 2017 Distributions and Transfers

***Land Board Meeting
August 18, 2015***



EFIB Staff Conclusions/Recommendation: Distributions for FY 2017

- Recommend an 11.8% (\$6.7 million) increase in total distributions:

	<i>Distributions To Beneficiaries</i>				<i>Transfer To Permanent Fund**</i>	<i>Added to Gain Bench- mark***</i>
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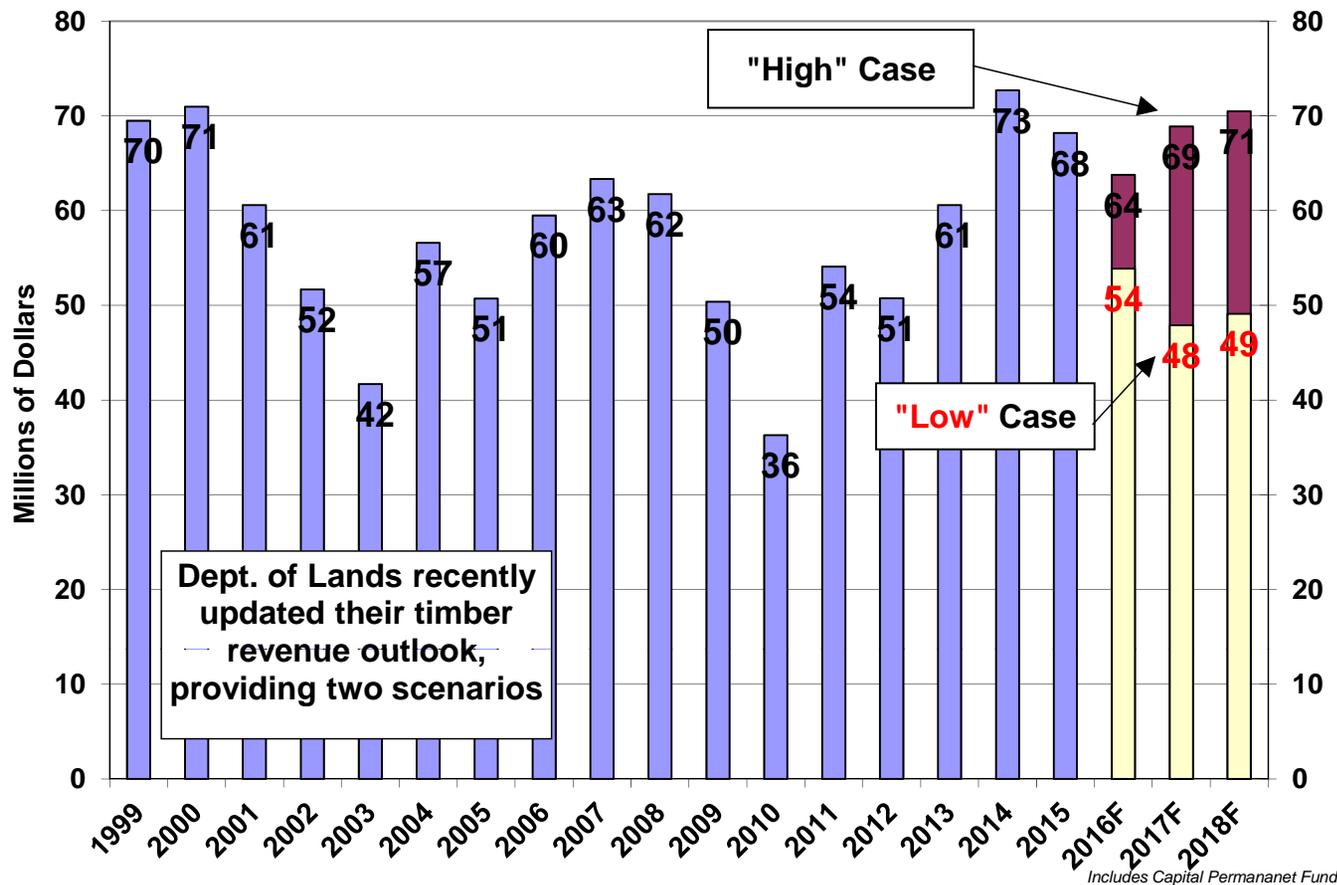
Based on 5% or 7% of 3-year average Permanent Fund balance, adjusted for transfers from Earnings Reserve and deposits from the sale of cabin sites for Normal School. State Hospital distributions held at previous year's level, to reflect forecast of lower land income, increased exposure to fund volatility due to cabin site sales. Public School distributions limited to 1/5th of the current reserve balance.

Current Situation

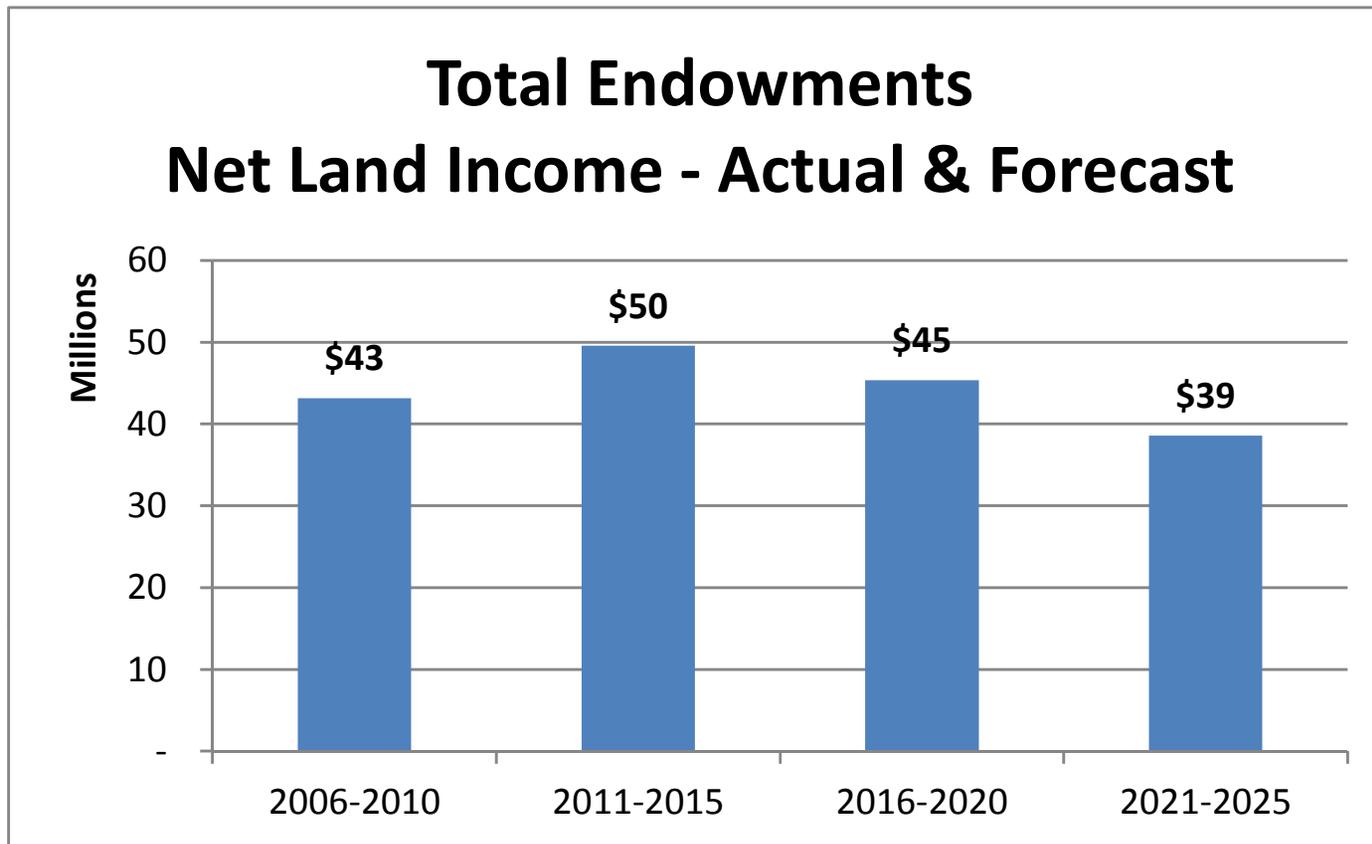
- Current year and next year's approved distribution is safe – every fund has reserves in excess of 5 years
- Record \$111 million of timber presold as of June, 2015: Guaranteed income over the next 3 years
 - Caveat: Lumber prices and buyers' financial reserves must be sufficient to allow them to fulfill their contracts on time
- Net land revenue in FY2016 is forecasted at \$42-\$52MM compared to \$56MM in FY 2015
 - Lumber prices were down 6% in FY 2015, log prices up 4%
- \$46MM of proceeds from cabin site sales were deposited in the Permanent Funds
 - Next 3 years: Additional \$85 million of site sales

Timber Revenue Forecast

Completed June, 2015

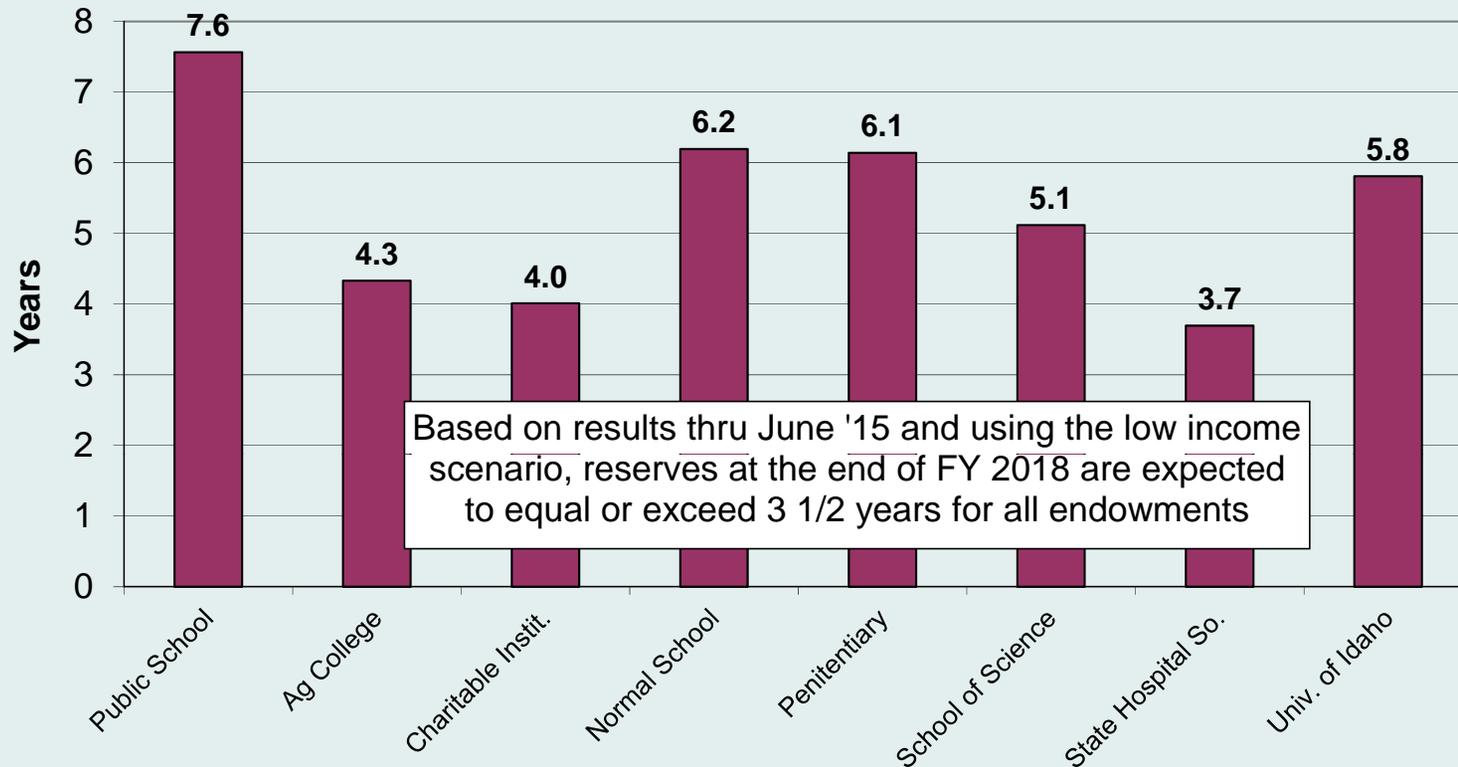


Total land income declines modestly due to lower timber and sale of cabin sites



Even under the “Low” revenue case, 2018 coverage ratios are strong

**Years of Distributions In Earnings Reserves
Forecast as at June 2018
Low Land Income, Zero Fund Market Appreciation Scenario**



Special adjustments reflected in the recommendation

- To offset the shift of earning power from the land to the fund, proceeds from the sale of cabin sites were excluded from the Permanent Fund for the purpose of calculating the distribution
 - Modestly reduces distributions for Normal School and State Hospital
- Due to the forecast of modest reserves by 2018, staff recommends that for State Hospital, no increase be given and that no transfer of reserves take place

Conclusion for Distributions

Scenario testing shows that the recommendations are prudent even under a “low” case

- Increase FY 2017 distributions for the 7 endowments with adequate reserves
 - Limit Public School to 1/5th of reserves
- Transfer excess reserves to the Permanent Fund for 6 funds to offset inflation/population and boost distributions
- Hold State Hospital distributions at current (FY 2016) levels
 - Retain excess reserves to protect future distributions from an expected downturn in timber income

Caveats for Distributions

- Forecasted coverage ratios under the “low” scenario are at acceptable levels for all endowments thru FY 2018, and probably beyond
- Therefore, a reduction in distributions in FY 2018 or FY2019 is not likely, but may be necessary if, for example:
 - Future returns on the fund are materially negative
 - Hardship extensions are offered on existing timber contracts
 - A material number of existing timber contracts are abrogated by purchaser bankruptcies
 - Timber prices or volumes fall below the level assumed in the “low” revenue scenario
 - Unforeseen environmental issues limit timber harvesting

Additional consideration: Transfers and the Gain Benchmark

- Six endowments have more than targeted years of reserves, so recommend the excess be transferred to the Permanent Fund
 - Transfers either offset Perm Fund losses or make up for inflation and population while boosting distributions
- The Land Board must indicate whether a transfer:
 - Increases permanent corpus (the Gain Benchmark), or
 - Makes up past losses in purchasing power
- Recommendation: There are no losses to make up, so add all \$39.5 million of the transfers to the Gain Benchmark as principal

Land Board Action Requested

- Recommend the Land Board approve the distributions, the transfers, and the classification with regard to the Gain Benchmark as shown below

	<i>Distributions To Beneficiaries</i>				<i>Transfer To Permanent Fund**</i>	<i>Added to Gain Bench- mark***</i>
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Appendix

FY 2017 Distribution Presentation



ESTIMATED ENDOWMENT DISTRIBUTIONS - FY 2017

(Fiscal year ended June 30 - \$ in millions - Adjusted for cabin site sale proceeds)

	Total	Public School	Ag College	Charitable	Normal Schools	Penitentiary	School of Science	State Hospital South	University
FY 2015 Distribution	\$ 52.0	\$ 31.3	\$ 1.2	\$ 3.9	\$ 3.1	\$ 1.7	\$ 3.9	\$ 3.6	\$ 3.3
FY 2016 Distribution	\$ 56.5	\$ 32.8	\$ 1.3	\$ 4.5	\$ 3.6	\$ 1.9	\$ 3.9	\$ 4.6	\$ 4.0
Earnings Reserves status (as of 6/15)									
<i>Earnings Reserve Policy (in years)</i>	5.0	5.0	7.0	5.0	6.0	7.0	7.0	5.0	7.0
Years of reserves, after transfer	5.5	5.0	7.0	5.0	6.0	7.0	7.0	5.3	7.0
Earnings Reserve Balance (6/15)	\$ 384.8	\$ 183.6	\$ 10.4	\$ 46.0	\$ 36.4	\$ 15.2	\$ 40.7	\$ 24.0	\$ 28.5
Permanent Fund - 3 Yr Avg Mkt Value	\$ 1,346.0	\$ 882.6	\$ 26.0	\$ 92.2	\$ 74.4	\$ 37.9	\$ 86.4	\$ 65.9	\$ 80.6
<i>Distribution % Per Policy</i>	5.1%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	7.0%	5.0%
2017 Distribution Calculation									
<i>% formula, before transfers to Perm Fund</i>	\$ 68.6	\$ 44.1	\$ 1.3	\$ 4.6	\$ 3.7	\$ 1.9	\$ 4.3	\$ 4.6	\$ 4.0
<i>Distribution constrained due to low reserves</i>		\$ 36.7						\$ 4.6	
<i>Distribution adjusted upward for transfers</i>			\$ 1.3	\$ 5.5	\$ 4.3	\$ 2.0	\$ 4.7		\$ 4.0
2017 Distribution Recommendation	\$ 63.1	\$ 36.7	\$ 1.3	\$ 5.5	\$ 4.3	\$ 2.0	\$ 4.7	\$ 4.6	\$ 4.0
% Change: 2017 vs. 2016 Distribution	11.8%	12.1%	4.6%	22.8%	18.1%	5.0%	21.8%	0.0%	0.7%
If Earnings Reserve > 5 years, consider Transfer to Permanent Fund									
ER balance (In years) pre-transfer to PF	5.6	4.2	8.0	10.0	9.8	8.0	9.4	5.2	7.1
ER balance (In years) post-transfer to PF	5.5	5.0	7.0	5.0	6.0	7.0	7.0	5.3	7.0
Recommended Transfer to Perm Fund	\$ 39.5	\$ -	\$ 0.9	\$ 18.3	\$ 10.9	\$ 1.4	\$ 7.8	\$ -	\$ 0.2
<i>Transfer % of Earnings Reserve</i>	10%		9%	40%	30%	10%	19%		

Coverage Ratio June 30, 2015

Years

12.0

9.0

6.0

3.0

0.0

Public Schod

Ag College

Charitable

Normal

Penitentiary

Sch of Science

Sate Hbsp So

University

Total

5.6

8.0

10.2

10.1

8.1

10.5

5.3

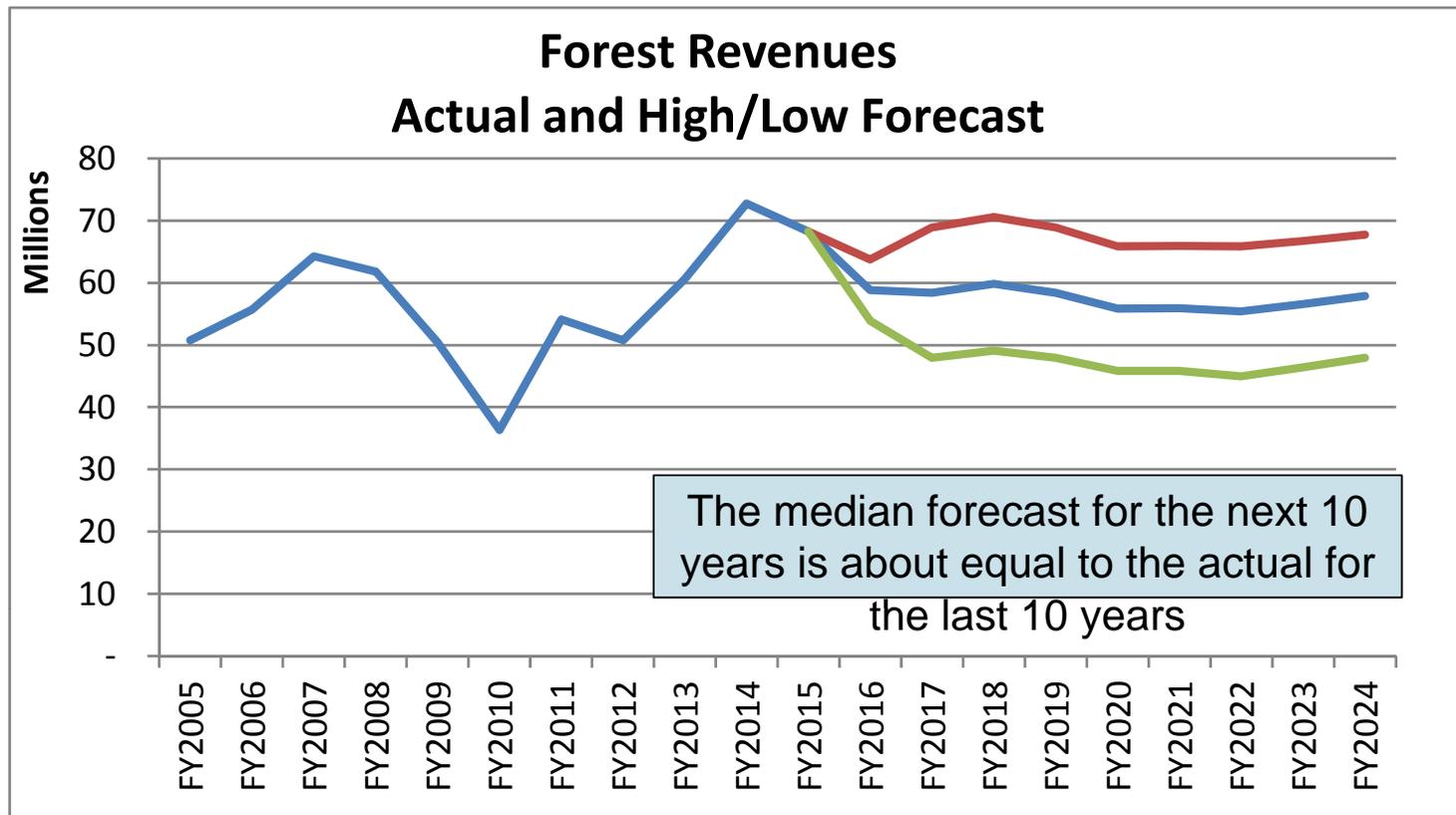
7.1

6.8

Earnings Reserves relative to 2016 distributions exceed five years for all endowments

Note: Does not include an undistributed cumulative gain above benchmark for Public Schod which remains in the Permanent Fund and will transfer to Reserves at 6/30/16.

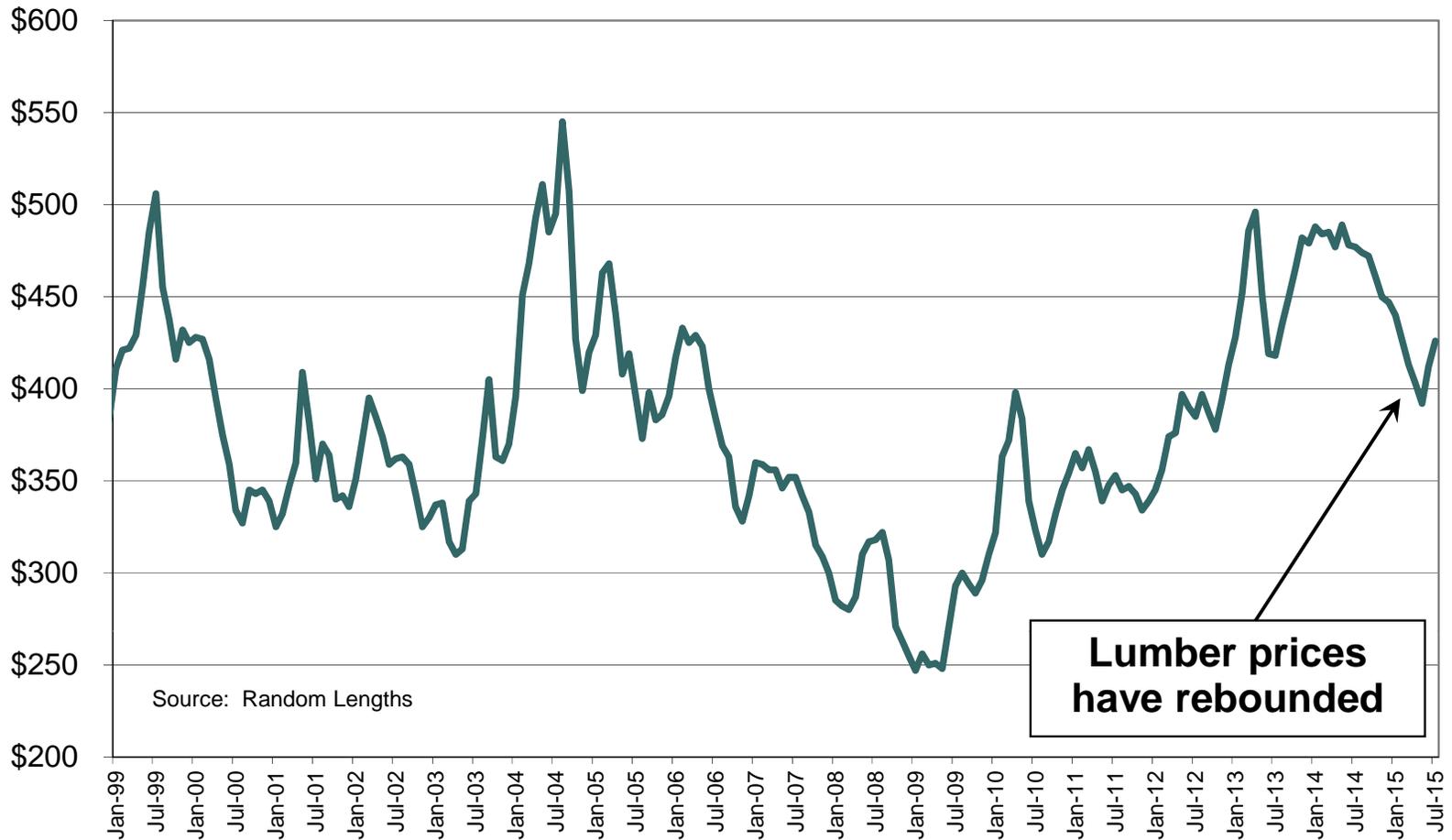
Timber forecast assumes a modest decline from FY14-15 peaks



Summary – Land Revenue Forecast

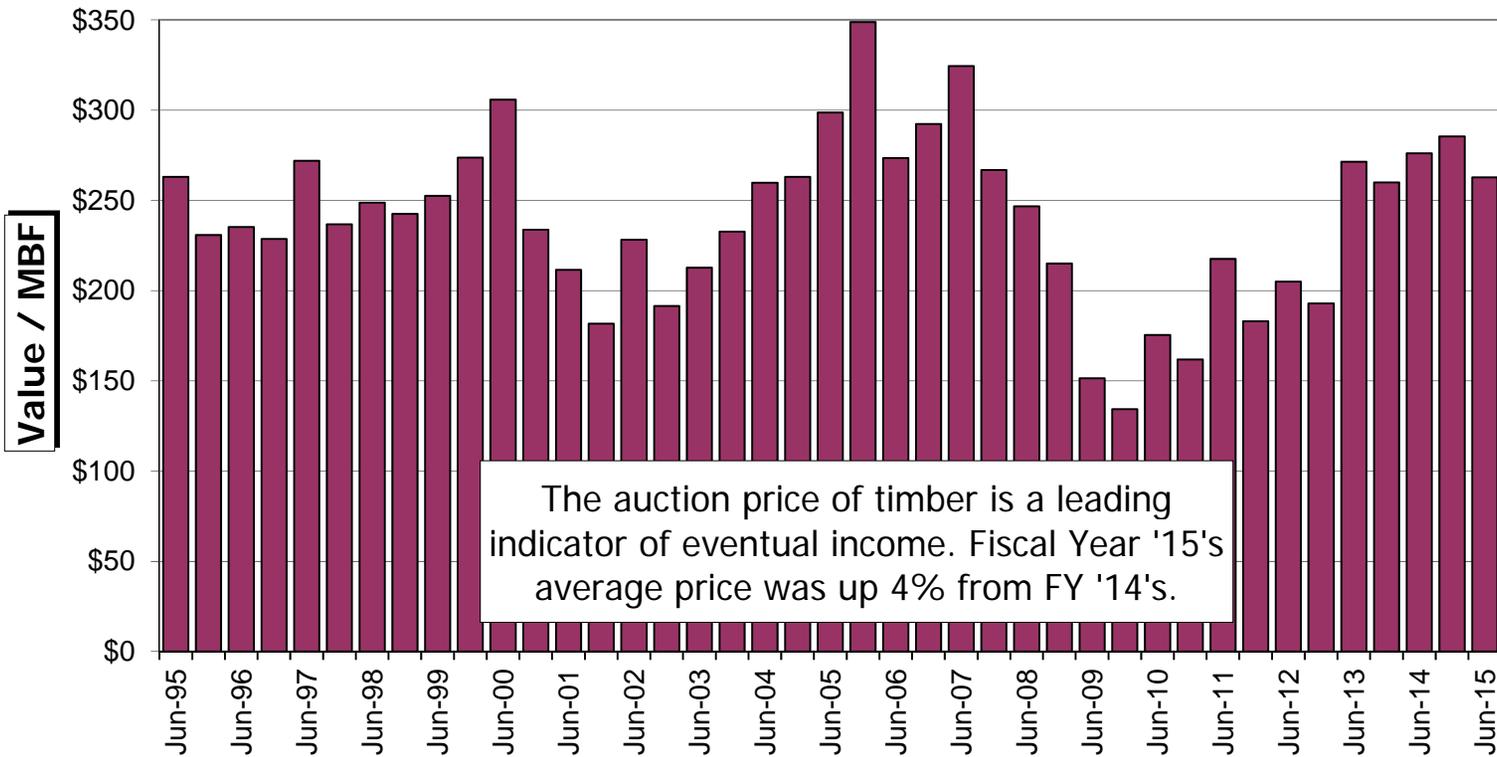
<i>Net Land Revenues</i>	<i>Public School</i>	<i>Ag College</i>	<i>Charitable</i>	<i>Normal School</i>	<i>Penitentiary</i>	<i>School of Science</i>	<i>State Hospital</i>	<i>University</i>
Projected Average Net Revenue (\$MM) (10 yrs 2016-2025)	\$ 25.2	\$ 0.5	\$ 3.8	\$ 3.3	\$ 1.5	\$ 2.1	\$ 2.9	\$ 2.6
Projected vs. Permanent Fund (% of FY15 adj. value)	2.6%	2.0%	3.6%	3.6%	3.7%	2.4%	3.5%	3.3%
Projected vs. Distribution (% of FY16 distrib.)	69%	40%	68%	77%	74%	45%	63%	64%
Historical Average Net Revenue (\$MM) (10 yrs 2006-2015)	\$ 25.0	\$ 1.0	\$ 4.3	\$ 2.8	\$ 2.0	\$ 3.3	\$ 3.9	\$ 3.4
Projected/Historical (% Over (Under))	1%	-47%	-12%	17%	-28%	-35%	-26%	-24%
Historical ± Variation % in Net Revenues (2 std deviations)	50%	160%	90%	100%	130%	110%	90%	110%

Inland Lumber Price Monthly - 1999 Thru July 2015 (\$/MBF)



Average Stumpage Price

(Auction Price)



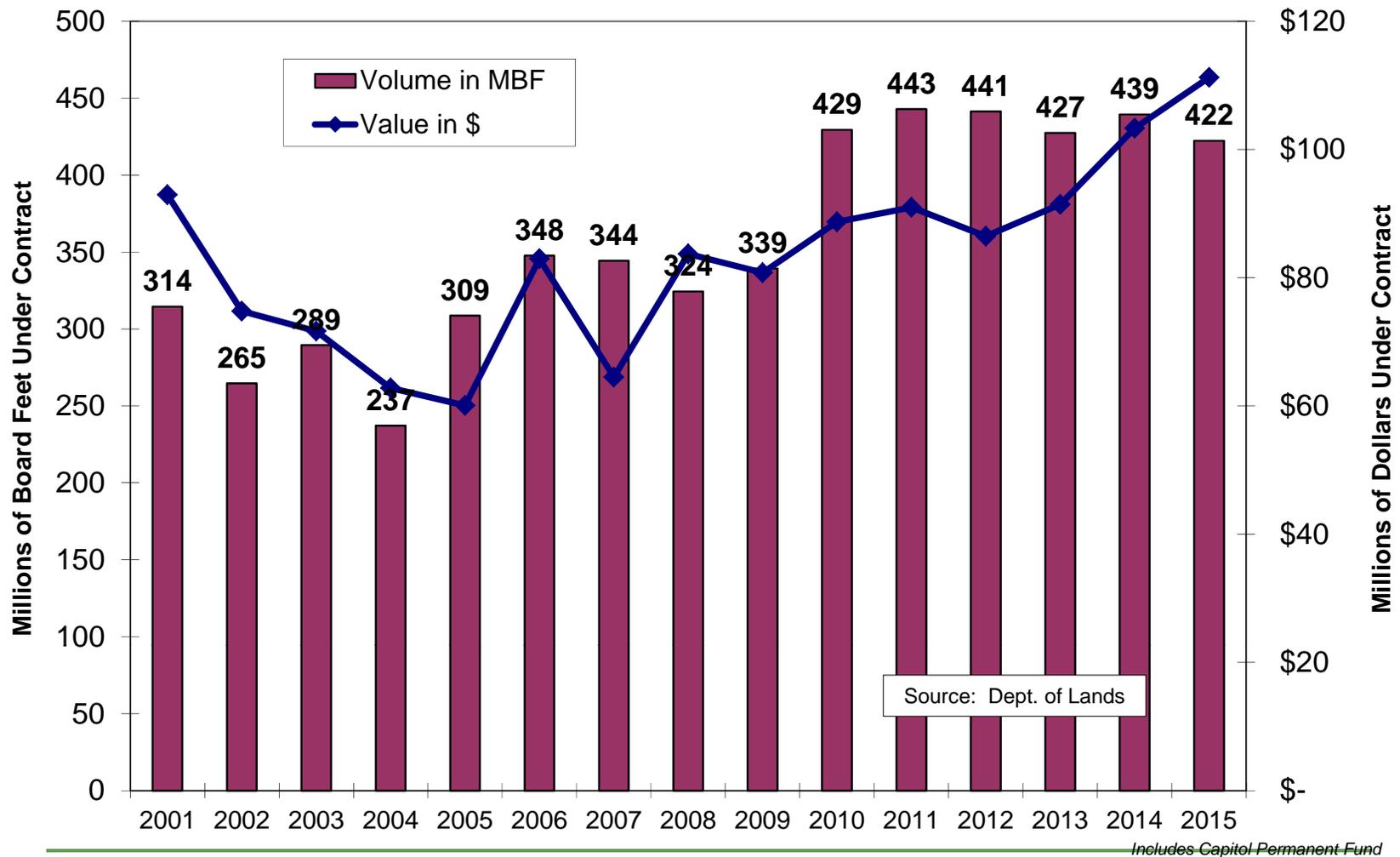
The auction price of timber is a leading indicator of eventual income. Fiscal Year '15's average price was up 4% from FY '14's.

Six Month Increments: January 1995 - June 2015

Source: Department of Lands

Log prices fairly steady for the last 2 ½ years

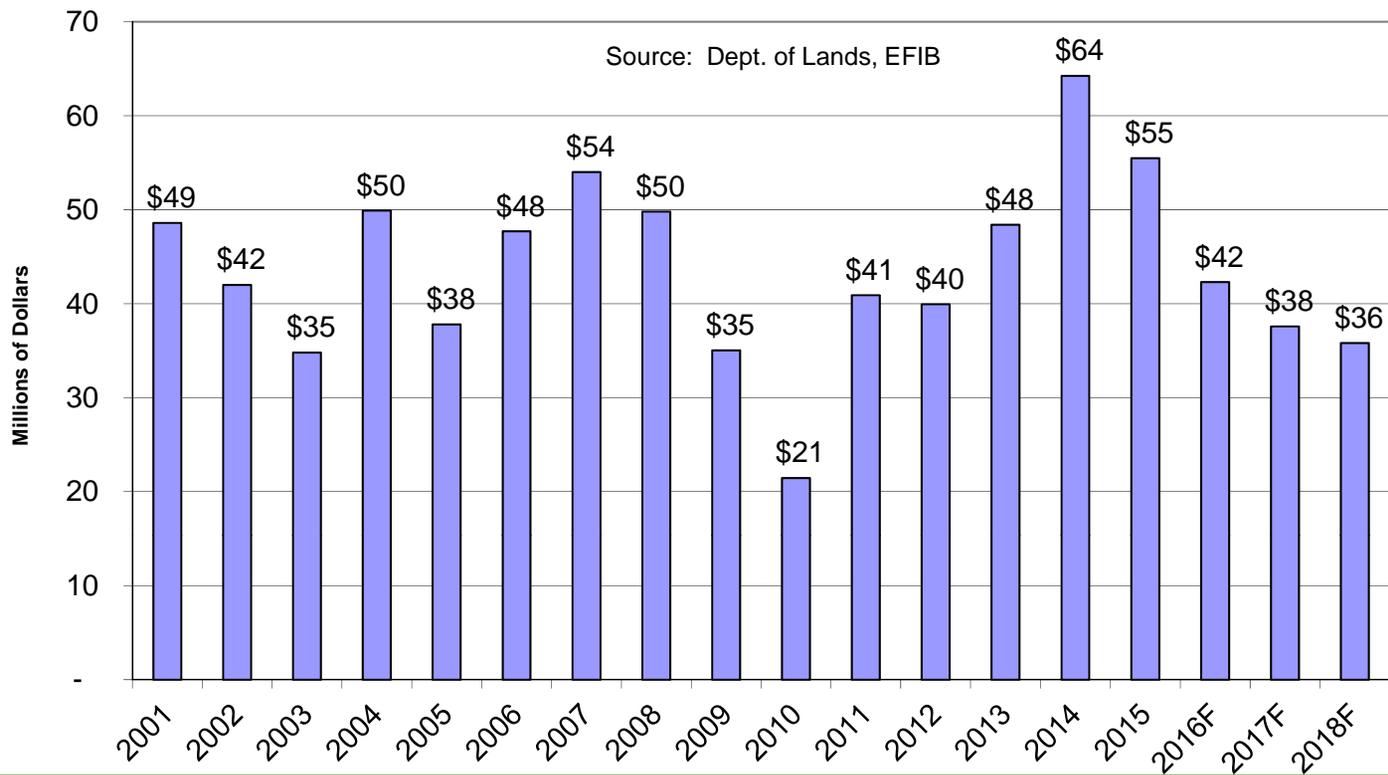
Dept. of Lands -- Timber Under Contract at Fiscal Year End



Record pre-sold timber volume at June, 2015

“Low” forecast is a “reasonable” worst case scenario given high contracted volumes

Net Endowment Land Revenues
Actual 2001-2015, "Low" Forecast 2016-2018



Distribution Policy Summary

The Land Board has adopted the following principles:

- Distribute 5% of the 3-year average value of the Permanent Fund each year (7% for State Hospital)
 - Adjusted for reserves, transfers and any other relevant factors
- Maintain Earnings Reserves at adequate levels (based on years of distributions)
- Consider transferring any excess reserves back to the Permanent Fund each year

Distribution Policy: Approved Priorities

The Land Board has adopted the following objectives/priorities for determining distributions:

1. Avoid reductions in total endowment distributions
2. Maintain adequate Earnings Reserves to protect distributions from temporary shortfalls in fund returns and land revenues
3. Grow distributions and permanent corpus faster than inflation and population growth