

STATE BOARD OF LAND COMMISSIONERS
December 21, 2010
Regular Agenda

SUBJECT

Cottage Site Plan – Processes to Unify the Estate

BACKGROUND

The leasing of State Endowment Trust Land for use as residential sites, known as cottage sites, has been active since the early 1900s. Over the decades the cottage site leases have been offered to potential lessees in an “as is” condition, raw land and nothing more; meaning that access roads, dry utilities [electrical power, cable, telephone], wet utilities [sewer and water] and the roles and responsibilities for the use and care of common areas, like roadways and access ways to the lake front, have not be developed or documented.

For the past several decades lessees have expressed a desire to purchase the State Trust Land that they have been leasing for residential use. A series of public auctions of cottage sites did occur during the late 1970s and early 1980s. Land Board minutes from this time period indicate that the sites offered for auction were chosen by lottery. The most recent cottage site transactions occurred in the form of land exchanges that were proposed by lessees during the late 1990s. The outcome of these land exchanges was the acquisition of a variety of asset types, including timberland and commercial buildings and parking lots in downtown Boise City.

On February 16, 2010, the State Board of Land Commissioners directed the Department of Lands to develop a plan to unify the estate [ownership] of the leased cottage sites located at both Payette and Priest Lakes. The Department, with the assistance of real estate consultants and legal counsel specializing in real estate and land use law, has developed the Cottage Site Plan (Attachment A). The foundation for the Cottage Site Plan and its recommendations is based upon four principles: 1) the State of Idaho Constitutional mandate for the management of the State Endowment Trust Land; 2) the Idaho Code, which provides for the types of transactions that can be used to modify the State Endowment Trust Land real estate portfolio; 3) the State Board of Land Commissioners Asset Management Plan; and 4) the Land Board’s mid-term Strategic Vision.

DISCUSSION

The primary objective of the Cottage Site Plan is to articulate a programmatic “market savvy” process for unifying the split cottage site estates by divesting of residential cottage sites. The processes to be employed should be the same processes that a prudent institutional real estate investor would use when seeking to maximize the long-term financial return to beneficiaries or shareholders. The completed Cottage Site Plan is provided as Attachment A.

In order to meet the plan objective, the cottage site program underwent a comprehensive evaluation which included review of: 1) the performance of the asset as it currently exists; 2) the existing conditions of the land itself and the encumbrances that impact these sites; and 3) the

current disposition methods authorized in both the Idaho Constitution and Idaho Code. Following is summary of the findings and recommendations:

- 1) **Consultant Finding #1:** As an asset type, the leasing of individual cottage sites at Payette and Priest lakes is fundamentally inconsistent with similar institutional grade portfolio assets and presents significant challenges for the Land Board to fulfill the constitutional mandate to maximize the financial return on the endowment lands to the beneficiaries. The continuation of cottage leasing under the existing or currently proposed rent formula appears to fall far short of the ability to maximize the financial return that could be generated from a mix of endowment assets.
 - **Recommendation:** The Land Board should direct the Department of Lands to dispose of the cottage sites in an orderly and expeditious manner that maximizes value and then reinvest the proceeds in institutional grade real estate assets using methods and procedures that are consistent with those of professional investors with similar fiduciary responsibilities.
- 2) **Consultant Finding #2:** There are a number of access, title and boundary issues associated with both leased cottage sites and adjoining deeded cottage sites at Payette and Priest lakes that make transferring title to the cottage sites legally and financially inadvisable until these matters are resolved.
 - **Recommendation:** The Land Board should direct the Department of Lands to complete the Lot Solutions Process, summarized in Cottage Site Plan document, by proactively addressing the need for formal access, accurate easements and subdivision platting associated with the cottage sites prior to implementing the unification processes as it is in the best interest of the beneficiaries, lessees and deeded property owners.
- 3) **Consultant Finding #3:** The legal mechanisms of disposal currently available to the Department of Lands are adequate (but not necessarily ideal) to allow for an orderly disposition process that will capture at minimum the appraised value of the cottage sites. While initial reinvestment of funds generated from disposition of cottage sites can be done with only administrative modifications to current practices, long-term professional management of an institutional grade real estate portfolio will require the flexibility not currently afforded by constitutional language.
 - **Recommendation:** The Land Board should: A) authorize the Department of Lands to make the administrative changes necessary to executing the disposition process outlined in Cottage Site Plan; and B) continue to pursue efforts that will allow for additional flexibility in the marketing and sales of certain endowment assets in a business-like manner and consistent with modern real estate practices.

SUMMARY

The Cottage Site Plan details recommended processes for unification of the split cottage site estates. These processes can be implemented under current constitutional and statutory

authorizations. The Plan reiterates the need for additional authorizations to provide more flexibility to offer transactions in a manner that is consistent with modern real estate practices. Finally, the Plan discusses the potential for substantially increasing the return to the beneficiaries through reinvestment of the disposition proceeds into institutional grade real estate assets aligned with the Strategic Vision adopted by the Land Board in October 2010.

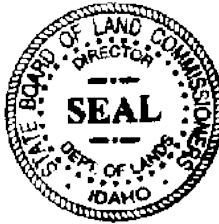
RECOMMENDATION

Direct the Department to:

1. Open a 90-day public comment period on the Cottage Site Plan to allow for review and comment by interested parties. Comment period will open on December 23, 2010 and will close on March 24, 2011.
2. Present the results of the public comment period to the Land Board as an information item at the May 2011 Land Board meeting.

BOARD ACTION

A motion was made by Attorney General Wasden to approve the Department's recommendation as outlined on page 3 of 3 of item number 6. Secretary of State Ysursa seconded the motion. The motion carried on a vote of 5-0.



ATTACHMENTS

- A. Cottage Site Plan – Processes to Unify the Estate
- B. Power Point Presentation

IDAHO DEPARTMENT OF LANDS

COTTAGE SITE PLAN



PREPARED BY

HEARTLAND LLC

DECEMBER 2010

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Executive Summary

FINDINGS AND RECOMMENDATIONS

- 1) **Finding:** As an asset type, the leasing of individual cottage sites at Priest and Payette lakes is fundamentally inconsistent with the Idaho State Board of Land Commissioners' (Land Board) constitutional mandate to maximize the financial return on the endowment lands to the Beneficiaries. The continuation of cottage leasing under the existing or currently proposed rent formula falls far short of maximizing the financial return that could be generated from alternative investments. The processes defined herein can be executed and funds reinvested over a 9-year period beginning in December 2011.
 - **Recommendation:** The Land Board should direct the Idaho Department of Lands (IDL) to sell the cottage sites in an orderly, expeditious manner that maximizes value and then reinvests the proceeds in institutional grade real estate assets using methods and procedures that are consistent with those of professional investors with similar fiduciary responsibilities.
- 2) **Finding:** There are a number of access, title and boundary issues associated with both IDL leased cottage sites and adjoining deeded cottage sites at Priest and Payette lakes that make transferring title to the cottage sites legally and financially inadvisable until these issues are resolved.
 - **Recommendation:** Following the Lot Solutions process summarized in this report, the Land Board should direct IDL to proactively address formal access, easements and subdivision platting issues associated with the cottage sites prior to disposition as it is in the best interest of the beneficiaries, the Lessees and deeded property owners.
- 3) **Finding:** The legal mechanisms currently available to IDL are adequate (but not necessarily ideal) to allow for an orderly disposition process that will capture at minimum the appraised value of the cottage sites. While initial reinvestment of funds generated from disposition of cottage sites can be done with only administrative modifications to current practices, long-term professional management of an institutional grade real estate portfolio will require the flexibility afforded by the proposed constitutional amendment allowing direct sale of properties held by the endowment.
 - **Recommendation:** The Land Board should A) authorize IDL to make the administrative changes necessary to executing the disposition process outlined in this document; and B) continue to advocate for the amendment to the State Constitution that will allow for direct marketing and sales of certain endowment assets in a business-like manner that is consistent with modern real estate investment practices.

Background

ENGAGEMENT OBJECTIVE

The Idaho Constitution, Article IX, Section 8, states that endowment lands are to be managed, “...in such manner as will secure the maximum long term financial return to the institution to which granted.” At the Land Board’s request, IDL is preparing programmatic strategies that will assist the Land Board better achieve this long-term core mission. The GGLO/Heartland Team was retained to, in part; devise a disposition process that can be integrated with a variety of other value-added land management strategies.

The primary objective of this document is to articulate a programmatic, “market savvy”, process for divesting of residential cottage sites and reinvesting the proceeds in institutional grade real estate assets. In this case, “market savvy” is defined as a process that would be employed by a prudent institutional real estate investor with full consideration of current market conditions seeking to maximize the long-term financial return to beneficiaries or shareholders.

PRIMARY CONSIDERATIONS

While IDL may endeavor to change some policy and legal constraints in order to implement an optimal disposition process, there are a number of considerations that necessarily shape any realistic approach to land management, acquisition and disposition of real estate investments. These primary considerations include the following:

Asset Types Should Match Mission

The Land Board’s fiduciary responsibility to the endowment is similar to that of other institutional investors and their endowments or pension beneficiaries. Institutional-grade real estate assets are generally defined as real property investments that are sought by institutional buyers and have the capacity to meet generally prevalent institutional investment criteria. Institutional real estate investments typically include office, retail, industrial, and apartment properties. Niche real estate asset types appropriate for a portion of an institutional portfolio include hotels, congregate care facilities, mixed-use properties (i.e., a property containing at least two use types), mobile home parks and natural resource lands. Five characteristics that distinguish institutional grade investments are summarized below followed by a comparison to IDL’s cottage sites.

Risk

Institutional Investor: Because institutions (pension funds, endowments, etc.) are investing money for the long-term, they seek lower risk properties with steady long-term returns. Office or retail buildings with long-term, “credit” tenants and larger apartment complexes are typical institutional acquisitions. Institutional investors generally avoid taking on construction or the initial lease risk of a new building that are typically born by developers and private companies that are willing to take on more risk for a higher return.

Cottage Leases: Traditionally structured ground leases are typically seen as efficient (very low administrative costs), low-risk investments with long-term steady revenue. The cottage site leases, however, are operating under a degree of legal ambiguity that to an outside private or institutional real estate investor would be seen as high-risk. The personal and emotional aspects of ground leasing single-family lots to individuals can

cause public relation and political interference in the effective management of and setting of appropriate lease rates for cottage leases and, therefore, most institutional investors would avoid this type of asset. The unorthodox ground lease structure (improvement purchase requirement at lease expiration) further increases the perception of uncertainty and risk that would, in turn, significantly raise the return expectations of an independent investor.

Efficiency

Institutional Investor: Investors looking for modest, steady returns seek to minimize expenses associated with those investments. As a result, institutional real estate investors desire the economies of scale that come with larger properties and secure long-term management contracts or absolute net (all expenses to the tenant) leases to minimize administrative and transaction costs.

Cottage Leases: The administrative costs associated with managing individual cottage site leases on 10-year terms combined with the administration efforts required to manage public relations as described above, places a substantial burden on the gross cash flow which is an additional reason why long-term institutional investors would not seek this type of asset.

Return Expectations

Institutional Investor: Traditionally, institutional real estate investors have targeted lower risk assets that provide single-digit returns, in the 7%-9% range.

Cottage Leases: The cottage leases historic return ranges from 1.7%-2.5% before taking into consideration full administration costs. Even if the cottage leases were a low-risk, efficient investment, returns at these levels would not be acceptable. While lakefront and lake view lots are very valuable and desirable, these attributes are irrelevant to an investor (or beneficiary) if there are legal or political hurdles limiting the ability to achieve market based returns.

Liquidity

Institutional Investor: Institutional grade investments are not unique to a specific investor and should be of such character to be an asset that other institutional investors would seek to add to their portfolio thereby providing liquidity and market valuation.

Cottage Leases: Land leases can be appropriate institutional-grade investments and provide desirable diversification of investment assets when they are structured to provide comparative rates of return net of administration costs, relatively low and defined risk, and adequate liquidity compared to other investment alternatives. Under the current lease structure, an institutional investor could not reasonably underwrite an acceptable exit strategy for the sale of the cottage lease portfolio to another institutional investor without risking a substantial diminution in value compared to the collective market value of the cottage lots if sold in fee to individuals.

Underperforming Asset

As discussed above, the cottage site leases are significantly underperforming as an asset. Much of this "underperformance" is attributable to decades of old lease management practices and economic realities that now result in a fundamental undervaluation of the leased sites and

consume department resources that are disproportionate to the historic and potential future financial returns from these assets.

Market Conditions

There is no escaping the dismal condition of the economy and the real estate market in particular. Any viable approach disposing of cottage sites must recognize the fact that the recession has reduced real estate values in all sectors. However, given the very low return on cottage site leases that the Land Board has been able to capture in the past and will likely be able to capture in the future through ground leases, the beneficiaries are far better off disposing of the cottage sites in a down market and reinvesting the proceeds in institutional grade assets with similarly reduced valuations but with far more potential to capture long-term appreciation.

Market Share

Compounding the challenges posed by the current market is that the leased cottage sites constitute a disproportionate share of lake oriented real estate at both Priest and Payette Lakes which increases the risk of formulating a disposition strategy that could oversupply the market, further suppresses values. Conversely, a long disposition process will suppress returns to the beneficiaries by holding capital in underperforming cottage leases rather than reinvesting in institutional grade real estate assets.

Preparation

Lot Solutions Process

Part of the analytical work in support of this effort has revealed that there are a number of access, encroachment, title, common area and boundary matters associated with both leased and deeded cottage sites at Priest and Payette lakes. It has been determined that proactively addressing these items is in the best interest of the beneficiaries, the lessees, deeded property owners and the future management of the adjacent State Trust Land regardless of the direction taken by the Land Board with respect to Cottage Site Plan. IDL's intent is to resolve inconsistencies, conflicts and ambiguities to preserve the long-term value of the endowment lands, as well as the continued use and enjoyment of both leased and deeded cottage sites. IDL has been directed to engage in the following activities, which are targeted for completion within 18-24 months.

- Survey all property boundaries, roads, utilities and easements associated with the leased cottage sites at both lakes;
- Identify potential areas of encroachment with regard to property boundaries and roadways;
- Work directly with lessees and deeded lot owners to resolve access and common area issues; and
- Create and/or adjust and record any property boundaries, plats, access easements and/or utility corridors deemed necessary to protect and enhance the long-term value of the endowment lands.

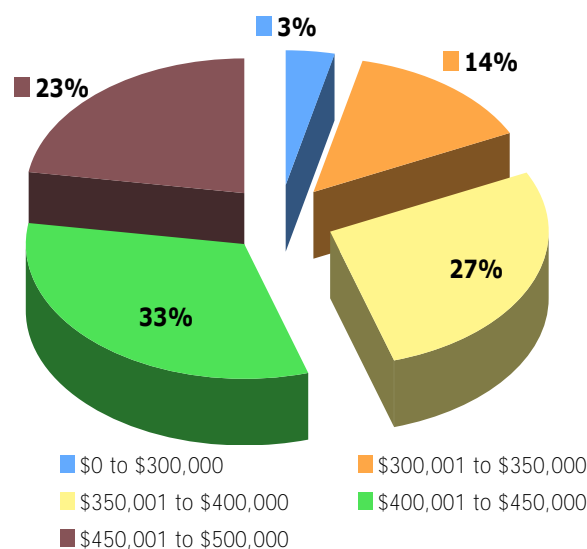
As stated previously in Finding and Recommendation #2, these legal items must be addressed before any dispositions occur, regardless of the disposition process that is finally adopted. The Land Board should not sell or exchange a cottage site that is not legally described, where access is legally ambiguous and even standard title insurance could be difficult to obtain in the future.

Valuation

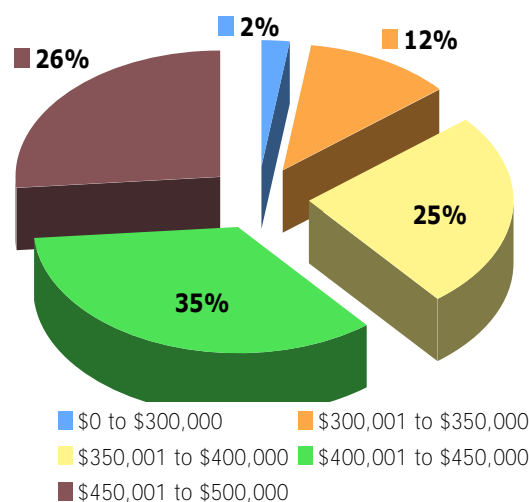
The value of real property can be determined by an appraiser who relies on available data to estimate the likely value given a willing seller and willing buyer or it can be ascertained by selling it on the open market to the highest bidder in an “arms length” transaction. The former is an expert opinion of value, while the latter reflects the value ascribed to a property by a buyer and seller influenced by all the idiosyncrasies inherent in a real estate transaction (time of year, personal circumstances, etc.). Because IDL is currently required to utilize a formal auction process whereby the minimum acceptable bid is the appraised value, a successful disposition strategy must net at least the appraised value of each site as of the sale date. The combined 2010 appraised value of the cottage sites is \$252 million. The valuation of the cottage sites at Priest Lake is \$152 million, representing 60% of the total value and the valuation of the cottage sites at Payette Lake is \$100 million, making up the other 40% in total valuation.

As illustrated in the charts below, Priest Lake has a relatively homogenous value range. The median (mid-point, half above and half below) 2010 appraised cottage site land value is \$428,000 and the average is a very close \$432,000.

Number of Cottage Sites by Value

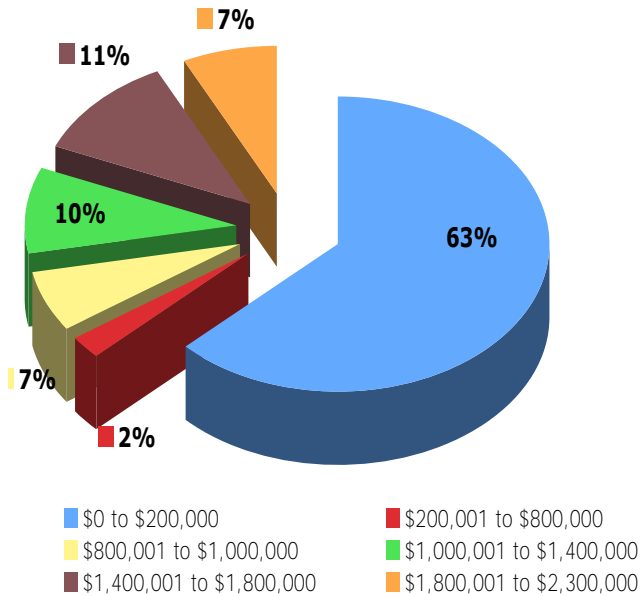


Total Priest Lake Cottage Site Value by Value Range

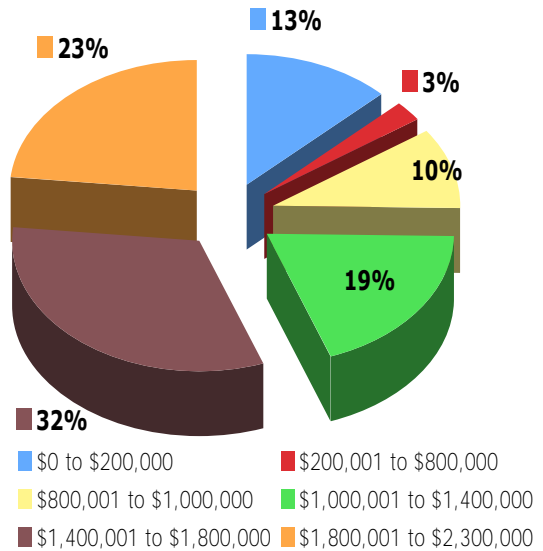


In contrast to the Priest Lake charts above the Payette Lake charts on the next page reveal a far less uniform value range reflecting the higher percentage of non-lakefront (2nd Tier) cottage sites at Payette Lake.

Number of Cottage Sites by Value



Total Payette Lake Cottage Site Value by Value Range



The median 2010 cottage site land value is \$130,000 while the average is \$594,000. The charts above show that because of the number of 2nd Tier sites, 63% of the lots comprise only 13% of the total value around the lake. And because of the very high value of the lakefront lots, 74% of the total portfolio value is held in 28% of the lots, which are valued at more than \$1,000,000.

While the minimum acceptable value of the portfolio will necessarily be determined through an appraisal process, the way in which IDL endeavors to capture that value creates an array of outcomes, which were primary considerations in formulating the disposition processes that follow.

Disposition Process

Based on the legal limitations and other considerations outlined in this document, IDL is proposing to adopt two disposition methodologies, which would be implemented concurrently after the Lot Solutions process has been completed. Both the Consolidated Exchange and the Rolling Auction would be voluntary and are variations of administrative procedures that are currently allowed by state law. The intent of both processes is to offer flexible options to lessees to better align their interests with those of the beneficiaries and the Land Board.

Timing

With every passing year, the lease rates on the cottage sites [based on the current lease contract] cost the beneficiaries roughly \$13M¹ in lost revenue; resulting in an undervaluing of the cottage sites as an asset by approximately \$66M². Orderly disposition of the cottage sites and reinvestment of the proceeds is in the beneficiaries' financial best interest. The beneficiaries are far better off disposing of the cottage sites in a down market and reinvesting the proceeds in institutional grade assets with similarly reduced valuations but with far more potential to capture long-term appreciation.

On March 16, 2010 the Land Board authorized IDL to renew the cottage leases for another 10-year term. As discussed above, the resolution of access issues and other matters associated with transferring title to the cottages sites is the primary obstacle to the near-term disposition of the cottage sites. IDL estimates that the Lot Solutions process (rectifying outstanding title and access matters) could be completed for the first groupings of lots as early as December 2011. Therefore, dispositions could begin to close immediately following the date the new plats have been recorded and then scheduled as the Land Board determines. For financial modeling purposes, an assumption was made that all but a limited number of cottage lease sites are sold and funds reinvested over a roughly 9-year period beginning in December 2011 - henceforth will be referred to as the Disposition Window.

Motivation

Collectively, the current cottage site lessees are the most motivated (emotionally and financially invested) and capable (most own improvements outright) buyers for the sites, therefore the disposition process outlined below is designed to convert as many lessees to buyers of the cottage sites within the Disposition Window and the limitations imposed by current state law. We would assert that the two voluntary processes outlined below will serve as powerful incentives for lessees to convert their lease through exchange or auction; and that the current leasing model itself is the primary disincentive for the majority of the lessees to want to continue to lease. As most lessees will attest, the concept of paying ever increasing land rent each year (indefinitely) and the constant uncertainty associated with Land Board policy and management, run counter to how most Americans see land ownership and real estate investments. Lessees will also consider that real estate values are down now but will rebound with the economy, which will mean increased competition (important under the auction process) and higher appraised values (an issue under both the auction and the Consolidated Exchange). Financial analysis of the two proposed processes indicates that these incentives and disincentives are directly aligned with the Land Board's motivation as a fiduciary for the beneficiaries.

¹ Projected cash flow from leases of \$4.6M versus \$17.6M at a return of 7% on \$252M reinvested in commercial real estate.

² The NPV of the proposed lease rates at a 3% discount rate is \$201M or \$51M less than the total value of \$252M for all cottage sites.

Exchange

Because exchanges are one of the few legal mechanisms through which lessees can currently obtain title to their cottage sites and since lessees, as a group, are motivated and capable buyers it is prudent to incorporate an exchange process into the disposition strategy with some administrative modifications. It should be noted that an updated exchange procedure was implemented in 2008 and the Consolidated Exchange option can be added as an additional tool that may be useful in many other situations beyond the cottage site situation. The proposed process is outlined below.

Past cottage site land exchanges followed the general steps outlined below:

- Lessee presents to IDL a commercial property that they assert has an equal or greater value than the current appraised value of the cottage site(s);
- IDL evaluates the investment opportunity and makes a recommendation to the Land Board as to compliance with the acquisition criteria;
- With approval of the Land Board, the lessee and IDL conduct a simultaneous close.

This approach to property acquisition is entirely contrary to the processes used by prudent investors who identify and pursue institutional grade assets to buy and sell as the market presents advantageous conditions. The fundamental shift embedded in the process below revolves around issues associated with control, the key elements of which include:

- **Timing:** Investors constantly evaluate market conditions in search of the right time to buy or sell. The predictability associated with the Consolidated Exchange will enable IDL to plan ahead and sequence transactions in ways that maximize the overall portfolio returns.
- **Asset Types:** The Consolidated Exchange process will allow IDL to target acquisitions that are both high quality assets on their own but also contribute to a well-diversified portfolio.
- **Due Diligence:** In order to responsibly underwrite any asset, a buyer must entirely control the due diligence process. As proposed, the Consolidated Exchange process affords IDL adequate time and exclusive control over this analytical process.
- **Portfolio Management:** Effective long-term management of the endowment portfolio will require the type of control of the acquisition process described above, as well as flexibility in the disposition of assets as market conditions change.

Consolidated Exchange Proposal

The following proposed Consolidated Exchange process modifies the existing exchange procedure by implementing the key elements discussed above.

- 1) **Application Window:** IDL will notify lessees when applications will be accepted for a Consolidated Exchange cycle. An application window of 30 days is recommended.
- 2) **Application:** Nine months prior to the targeted exchange date (Close of Escrow), lessees will have an opportunity to indicate their interest in participating in the forthcoming exchange by

submitting an application and a \$500 non-refundable application fee for each cottage site, which will be used to pay for an appraisal of land and improvements.

- 3) Appraisal: The appraisal of land and improvements will occur once the application window has closed. The result of the appraisal work is needed to complete the application review step.
- 4) Application Review: If the cumulative value of the pledged cottage sites meet or exceed IDL's minimum reinvestment target of \$20 million (or another amount at IDL's discretion), IDL will notify the lessees that their application has been accepted.
- 5) Earnest Money Deposit: Upon acceptance, lessees will be required to make an earnest money deposit equal to 6% of the appraised value of the cottage site (land only) into an interest bearing escrow account³. One-half (3%) of the Earnest Money deposit will be non-refundable but applicable to the purchase price at closing while the other half (3%) will be used to pay for exchange expenses such as due diligence reports, legal and escrow costs. The application, appraisal and deposit process will take no more than 60 days from the date of application, with the Close of Escrow concluding 7 months later.
- 6) Investment Identification and Due Diligence: During the 7 months following the acceptance of the exchange applications, IDL will identify one or more investment targets. Investment targets will be identified and evaluated solely by Department staff and contracted agents acting solely on its behalf. Investment targets will remain confidential until such time as they are under contract by IDL.
- 7) Funding: No less than 45 days prior to the targeted exchange date, IDL will issue a Notice to Fund, instructing all participating lessees to deposit the balance of the purchase price of their cottage site (appraised value less the applicable portion (3%) of the Earnest Money deposit) into escrow within 15 days. Lessees that fail to fully fund by the deadline forfeit their deposit and are eliminated from the exchange.
- 8) Closing: IDL and a qualified escrow agent will orchestrate a simultaneous closing(s) whereby the escrowed funds are used to close on the purchase of one or more investment targets and title to cottage sites are transferred to the lessees.
- 9) Targeted Frequency: IDL will conduct a Consolidated Exchange every six months during the Disposition Window providing minimum thresholds are met.

Considerations

Benefits:

By eliminating many of the problems inherent in the current exchange process, the Consolidated Exchange process outlined above represents a win for lessees, IDL, the Land Board and, most importantly, the beneficiaries.

- Lessees will no longer need to pay fees and commissions to outside agents to pursue exchange opportunities with the hope of finding an asset that is acceptable to IDL. Lessees will also be able to target the timing of their participation in an exchange to coincide with cash availability.

³ Lessees would be able to review the appraisal before committing to the exchange and depositing the earnest money into escrow.

- IDL will be empowered to proactively and methodically execute a reinvestment strategy that takes advantage of market conditions and creates an institutional grade portfolio of high quality assets that are aligned the long-term objectives of the endowment.
- The Land Board members will be insulated from special interests seeking to circumvent the process by directly presenting investment proposals to Land Board Members and their staffs.
- The beneficiaries will achieve long-term equity growth and increases in cash flow that appear unachievable with cottage site leases.

Limitations:

- Lessees wanting to take part in the Consolidated Exchange process described above will need to either have the cash necessary to buy their cottage site or arrange for financing. Given the recent recession and slow recovery, both cash and access to financing are in short supply, which may limit the number of lessees able to participate in this process.

AUCTION

As discussed throughout this report, given market depth, economic conditions and emotional and financial commitment, lessees represent optimal buyers of the cottage sites and it is in everyone's best interest to convert as many as possible to buyers. If the Land Board were a private landowner in the same circumstances but without the current restriction on the methods for selling endowment lands, it would likely choose to negotiate sales directly with the lessees. However, as current law prohibits this approach, a public auction is a necessary component of a realistic disposition process that is not dependent on successfully amending the State Constitution.⁴ The following auction process is proposed to be used in concert with the Consolidated Exchange Process discussed above and incorporates many procedural elements that were put into place in 2009⁵.

Voluntary Rolling Auction Proposal

- 1) Application Window: IDL will notify lessees when applications will be accepted for a Voluntary Rolling Auction cycle. An application window of 30 days is recommended.
- 2) Auction Application and Deposit: Six months prior to the auction date (Close of Escrow), lessees will have an opportunity to indicate their interest in participating in the forthcoming auction by submitting an application and a \$500 non-refundable application fee per cottage site, which will be used to pay for an appraisal of land and improvements.
- 3) Appraisal: The appraisal of land and improvements will occur once the application window has closed. A result of the appraisal work is needed to complete the application review step.
- 4) Auction Application Review and Administration Fee: After a brief legal review of the property (approved improvements, liens, etc.) and an appraisal of both the land and improvements, IDL will notify the lessees that their application has been accepted. An application might be rejected if the property itself is found to have a physical or legal issue that could not be cleared up prior to the auction date.

⁴ See Recommendation 4 regarding why the proposed constitutional amendment is still necessary to allow long-term effective management of the institutional grade real estate portfolio that this process envisions creating for the beneficiaries.

⁵ The Voluntary Auction process does not negate the involuntary auction process that occurs upon lessee's breach of the lease agreement.

- 5) Acceptance and Deposit: Upon acceptance of the application by IDL, lessees will be required to deposit an Administration Fee equal to 1% of the appraised value of the cottage site (land only) into an interest bearing escrow account.⁶ If the auction is successful (the minimum bid is met or exceeded) then the buyer (if someone other than the lessee) will pay the Administration Fee of 1% and the lessee's deposit will be returned. If the auction is not successful (no bids in excess of the minimum) then the deposit is forfeited.
- 6) Installment Payment Application: Within 30 days of Auction Application acceptance, bidders that wish to purchase the property at auction can make an application to make installment payments to IDL for the purchase of the cottage site only (i.e. no financing will be provided for the purchase of improvements). Installment contracts will be available at the following terms and conditions:
- a) Interest Rate and Term:
 - i) 3 Years at 1.0% over IDL's Department Transaction Rate which is based on the 30-year mortgage rate (4.25% as of 12/10) = 5.25%.
 - ii) 5 Years at 1.5% over transaction rate = 5.75%
 - iii) 7 Years at 2.0% over transaction rate = 6.25%
 - b) Payments: Monthly payments will be based on a 30-year amortization schedule with a balloon payment at the end of the term. All mortgages will be structured to be paid off by the end of the Disposition Window (December 31, 2020) regardless of when they start.
 - c) Down Payment: A down payment equal to 10% of the appraised land value of the cottage site will be required.
 - d) Security Instrument: A first position (unsubordinated) mortgage deed of trust recorded against the subject property (unified title, land and improvements) will be the sole security for the debt.
 - e) Fees: A one time, non-refundable fee of \$250 will be charged upon submittal of the Installment Payment Application.⁷ A fee equal to 0.5% of the note will be payable to IDL as part of escrow.
- 7) 3rd Party Mortgage Servicing: IDL will contract with a 3rd party loan servicing company to collect installment payments and manage delinquencies and foreclosures. Loan servicing of this type of mortgage note is typically provided for very large mortgage portfolios, however, even for a small portfolio (likely less than 450) the 3rd party costs which include a one-time setup fee of \$8-\$12 per note and \$6-\$10 per month would be very efficient for IDL.
- 8) Advertising: State law requires that the pending auction of the property be advertised for four (4) weeks prior to the auction; however, IDL will initiate an advertising campaign (print, web etc.) in order to maximize the attendance at each oral auction.
- 9) Minimum Bid: The appraised value of the property (land and improvements) establishes the minimum bid at the public auction. The property will be sold to the qualified bidder submitting the highest bid.
- 10) Earnest Money: An interested bidder will be required to submit the required earnest money deposit equal to 3% of the Minimum Bid, in the form of a bank-issued check, such as a cashier's check or certified check, to IDL at the time of auction in order to become a qualified bidder. The earnest money from the successful bidder will be considered earned and becomes non-refundable liquidated damages in the event of the purchaser's default.

⁶ Lessees will be able to review the appraisal before committing to the auction and depositing the earnest money into escrow.

⁷ Because IDL already owns the land and is simply accepting payment in installments for the purchase (vs. extending a loan like a bank) underwriting will be limited to the asset itself and not the credit worthiness of the buyer.

11) Other Bidder Qualifications and Limitations:

- a) Bidders must be 18 years of age and must be citizens of the United States or must have declared their intention to become U.S. citizens.
- b) A bidder will be required to sign an affidavit signifying that they have not exceeded the 320-acre lifetime limitation of state endowment land purchase of which no more than 160 acres can be University Endowment land.
- c) If the bidder is represented by another person, the representative must have a signed and notarized Verification of Bidder's Representation form from the purchaser, along with U.S. approved picture identification.
- d) Bidders must provide IDL with proof of financial ability to pay full purchase price at closing, five (5) working days prior to date of the auction. Acceptable proof of such financial ability shall be: (1) A letter from a financial institute clarifying bidders prequalification to place a bid at no less than appraised value or (2) A cash (or cash equivalent) deposit of the full appraised value, less the amount of bidders deposit with the Idaho Department of Lands and less the amount of installment financing being provided by IDL.
- e) The successful bidder will be responsible for a fee equal to 1% to pay for all costs of sale including appraisal, advertising, closing costs and title insurance premiums. The successful bidder will provide this payment at the close of the auction.

12) Frequency: IDL will conduct one or two public auctions (multiple lots would be auctioned at the same time) at each Lake per year between the first week of July and the last week of August for the duration of the Disposition Window.

Considerations

Benefits:

- The auction process described above is allowed under current state law. Negotiated direct sales might have some beneficial elements but the delay and uncertainty associated with waiting for a constitutional amendment to allow direct sales is not in the best interest of the beneficiaries or the lessees.
- Appraised values may rise or fall somewhat during the Disposition Window but at the time of sale the State is assured of getting Fair Market Value (FMV) of the Cottage Site as determined by appraisal.
- Because this is a voluntary rolling auction, it is reasonable to expect that a majority of lessees that choose to enter the auction are planning on making a competitive bid to buy the cottage site themselves. With these motivated buyers involved there should be fewer failed auctions and no "flooding" of the market.
- With mortgage financing in short supply, IDL's ability to accept installment payments for a defined period has several benefits to the endowment beneficiaries, the lessees-turned-buyers and the Land Board.
 - Beneficiaries: As discussed above, under the existing lease structure, the beneficiaries receive 1.7%-2.5% on the value of the endowment lands each year (before expenses). The changes proposed by the Land Board will result in a cash return below 4% for the foreseeable future. A cottage site buyer that makes installment payments as outlined above will immediately begin returning between 5.25% and 6.25% of the land value to the beneficiaries.
 - Lessees: For lessees with debt free improvements, the ability to finance the purchase of the lot after the auction limits the amount of up front cash (10% down payment) that would be required compared to the Consolidated Exchange option. And while annual cost to the lessee will necessarily increase (annual loan payments will exceed current lease rates) ownership of the unified title will build equity in the asset over time, remove uncertainty associated with the current leases

and allow lessees to rent the property out to generate income if they so desire.

- Land Board: The staggered installment terms of 3, 5, and 7 years proposed above, would create a steady and predictable flow of cash into the land bank that can be reinvested as financially advantageous opportunities arise. In the meantime, the Land Board is able to meet its fiduciary responsibility to the beneficiaries with the installment payments, which come with a greatly reduced administrative cost.

Limitations:

- Failed Auction: In the event that an auction fails (lessee elects not to bid and no other bids are received that meet or exceed the minimum) then the lessee must continue making lease payments. For lessees hoping to cash out their improvement value through the auction process (versus buying their lot), a failed auction does not preclude the lessee from applying for auction again at some point in the future.
- Obviously, those lessees that choose to finance the lot purchase with IDL will have to refinance or otherwise raise sufficient cash to payoff the note at the end of the term. To a lessee this introduces some measure of risk in that interest rates or mortgages for second homes may be higher and/or more difficult to obtain in the future.

DISPOSITION-REINVESTMENT FINANCIAL PROJECTIONS

As discussed throughout this document, the structure and timing of cash that the disposition processes will generate is primarily dependent on the decisions that will be made by the 521 cottage lessees and their families. The following simple diagram illustrates the lessee decision-making process.

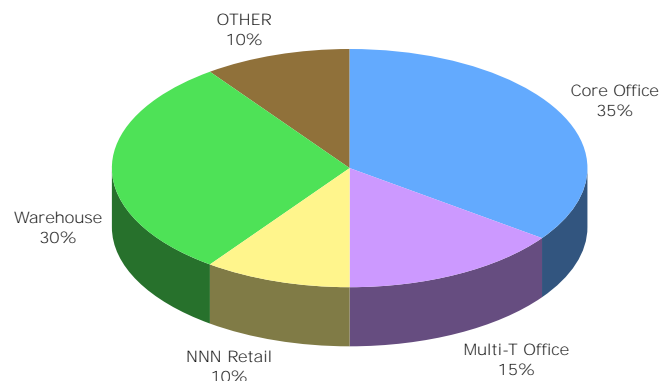


The following section summarizes the key assumptions and findings associated with the disposition-reinvestment scenario. The most influential assumptions are discussed below.

- *Continued Leasing:* The Consolidated Exchange and Voluntary Auction processes do not preclude lessees from continuing to lease their sites but it does include several incentives and disincentives to doing so. The ability to buy the cottage site through more than one mechanism will be the primary incentive for most lessees to participate. The existing and currently proposed leasing model itself is the primary disincentive. As most lessees will attest, the concept of paying ever increasing land rent each year (indefinitely) and the constant uncertainty associated with participation in a split estate situation run counter to how most Americans view an investment in real estate. Lessees will also consider that while real estate values are down now, they will rebound with the economy which will mean increased competition (important under the auction process) and higher appraised values (an issue under both the auction and the Consolidated Exchange). The expectation is that the majority of lessees will spend 2011 considering the options while IDL executes the Lot Solutions process discussed above and then chose a disposition process that best suites their financial situation within the following 3-4 years.

- *Exchange vs Auction:* As discussed above there are pros and cons to each process; however, most lessees will base their decision on their personal financial circumstance. Lessees with sufficient financial resources to participate in an exchange may do so to avoid the unknown of a public auction. Lessees who are attracted to financing through IDL (installment payments) or would simply like to liquidate their asset will more likely opt for the Voluntary Rolling Auction.
- *Finance vs. Cash:* Consolidated Exchanges are by definition all cash transactions from IDL's perspective but the auction process detailed above could be all cash or use short-term financing or installment payments. Because of the tight credit markets and the impact of the recession on other investments, it is assumed that only 10%-20% of auction buyers are all cash.
- *Values:* State law requires that transactions will be based on a current appraisal regardless of timing or process. For financial modeling purposes a modest (2%) annual escalation of 2010 land values is used to project a value at the time of sale. Because cottage leases are a percentage of the appraised or assessed land value, if land values actually decline, the disposition process herein still results in significant financial benefits over continuing the cottage lease program.
- ***Reinvestment:* The final and most important aspect of this process is the reinvestment of cash into a diversified, institutional grade portfolio that allows for distribution of interest and investment returns to the beneficiaries.** The mixture of asset types illustrated in the chart below was assumed to be acquired with cottage site funds.

Sample Portfolio Diversification



The reinvestment projections are primarily influenced by the three key factors identified below:

- Capitilization Rate (Cap Rate): There are two cap rates in the reinvestment projection. The "entry cap" is the return on the investment at purchase and the "exit cap" sets the sale price at the end of the investment. Cap rates vary over time and by product type. A range of 6%-8% is incorporated into the model.
- Escalation Rate: Model projects a 4% average annual escalation of net income during the period in which an asset is held. While year-over-year rent steps may be 2.5%-3%,

periodic market adjustments, renewals and re-tenanting increases the long-term average for the purposes of modeling.

- **Discount Rate:** The discount rate represents the investor's minimum return expectations given the risk profile of the asset or asset class. For the purposes of financial modeling a discount rate of 5.5% was used for all product types.

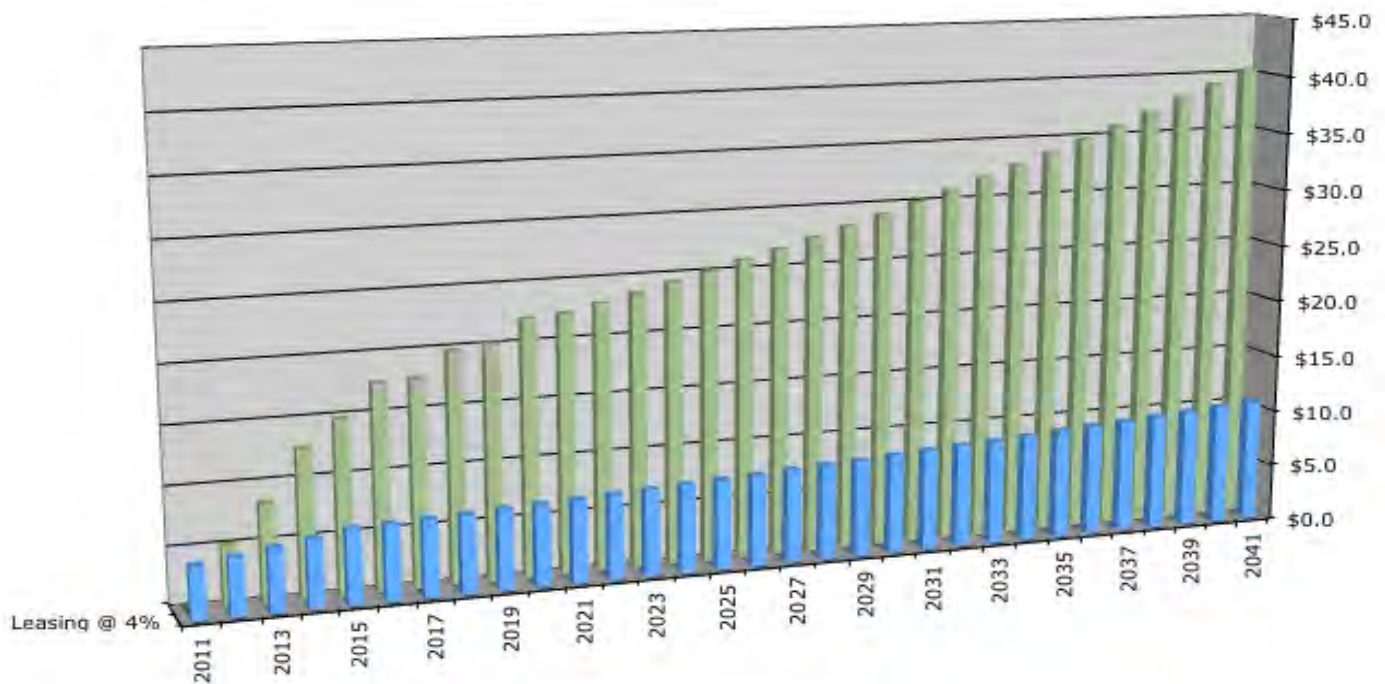
Reinvestment will be guided by the Strategic Vision document adopted by the Land Board in October 2010. The overall goal of the Strategic Vision is to diversify the land asset portfolio in a manner that will result in a more consistent and less volatile revenue stream for the beneficiary groups. The Strategic Vision document is included in its entirety as Appendix A of this Plan.

PROJECTED BENEFIT OF REINVESTMENT

As illustrated in the chart below, by executing on the disposition and reinvestment processes outlined above, the Land Board would be maximizing the long-term financial value of the cottage sites, ultimately doubling the annual distributions within the first decade.

Because the financial analysis is focused on the major components of the process, the projection below assume that all leased lots are unified and disposed of over the next decade.

Beneficiary Net Cash: Cottage Leasing vs. Disposition-Reinvestment



- Continued leasing shown in blue.
- Reinvestment of proceeds from disposition of cottage sites shown in green.

Appendix A

MID-TERM VISION AND STRATEGY FOR STATE TRUST LAND ASSET MANAGEMENT AND PERFORMANCE

Adopted October 2010

By

Idaho State Board of Land Commissioners

STATE BOARD OF LAND COMMISSIONERS

October 19, 2010

Regular Agenda

SUBJECT

Mid-term Vision and Strategy for State Trust Land Assets and Performance

BACKGROUND

At the Idaho state board of land commissioners meeting held September 21, 2010, the department led a discussion with the board regarding strategies and plans that could, over the next 10-20 years, substantially improve annual revenues available for beneficiary distribution. Attachment A - *Endowment Land Assets, Strategic Planning Vision*, provides a summary of the portfolio review performed by the agency. The resulting strategy provides a roadmap to focus efforts on activities that achieve the desired improvements necessary to meet the trust mandate of maximizing the long-term financial return to the beneficiaries.

DISCUSSION

The protracted downturn in the national and local economy heightens the awareness and importance of the trust manager's role in providing distributions to support ongoing beneficiary needs. As the board and department contemplate strategy necessary to improve current asset performance and to insure long-term viability of land revenue opportunities, we reflect on the philosophy articulated by the Board in the Asset Management Plan adopted in 2007. The overarching management philosophy is shown below, with points #2 - #5 being particularly relevant to the current discussion:

- Manage the endowed land and financial assets as a whole trust on a total return basis.
- Seek to **optimize risk and return** from both the endowments' land and financial assets **through diversification of holdings**.
- **Ensure that significant land holdings will be maintained in perpetuity**, since they provide material diversification and inflation protection to an endowment's portfolio.
- **Seek to reposition parcels to reduce risk, lower management costs and increase prospects for immediate and sustainable income**, recognizing that much endowment land remains in the original scattered parcels obtained from the federal government.
- **Provide for the appropriate and reasonable management expenses** of each endowment from its own income.
- Accommodate public use of endowment lands, to the extent feasible, provided such use does not impair financial returns.

Attachment A – *Endowment Land Assets, Strategic Planning* provides an outline to discuss the board and the department's ongoing review of the land portfolio. The performance of

asset types was examined, including, but not limited to, a review of portfolio and individual trust dependence on certain market sectors, ways to enhance the performance of existing assets, and revisiting the work of the Endowment Land Transaction Advisory Committee, which underscores the need for additional flexibility related to certain business transactions. The outcome of the analysis is a strategy that could double net revenues and significantly diversify holdings over the next 20 years. Instead of averaging \$48 million in net revenue per year, the land portfolio could average as much as \$100 million in net distributable revenue for trust beneficiaries. Increases and stability in land portfolio performance also has positive impact on financial returns by providing a more reliable revenue stream for the Endowment Fund Investment Board to place in the market.

Focus is the key to delivering the projected result. No question, Timberlands and forest management have produced solid historical returns for trust beneficiaries. In fact, about 85% of annual distributions to beneficiaries come from timber activities. Timberlands are and will continue to be a core asset for the trust. Continued viability of this earnings stream is vital and our ongoing commitment is demonstrated by the Land Board's Forest Asset Management Plan strategy adopted in 2009.

Steps are being taken to streamline management costs and processes in a variety of other endowment programs; however, to effect substantive change in overall portfolio performance resources should be channeled to activities that produce the "biggest bang for the buck". That means focusing on transitioning and growing commercial income producing assets.

The term commercial assets cover a broad array of investments. The trust has a small portfolio of commercial office/retail properties. Over the past 10 years the department has grown in its ability to effectively evaluate and manage these assets. Growth in the office/retail sector, in geographically strategic locations, is warranted as the 20 year average historical return in these industry sectors is 7% (NCRIEF statistics).

A more important commercial growth strategy involves the identification and development of existing land assets for alternative energy uses such as wind, geothermal and solar operations. A variety of resource material exists to aid in identifying lands that meet the qualifying criteria for such opportunities. The department is developing new GIS tools and tapping into key knowledge centers like the Office of Energy Resources to better understand necessary market factors for success. The results will help the trust to begin proactively marketing endowment lands for these uses. There are several benefits to this strategy: 1) traditional natural resource use can often continue and 2) the ability to simply transition and retain, in perpetuity, existing land that perhaps represented an underperforming asset.

Moving the financial performance of a land portfolio this size, in a 10-20 year time period, takes leadership and focus. The board and the department believe the "best bang for the buck" is to target resources in primarily two sectors, the care and feeding of its vital Timberlands and transitioning and growing Commercial Income Producing assets as described above. We can be proud of the fact that we will double beneficiary distributions without increasing taxes for the citizens of Idaho. We can begin to achieve these goals by redirecting the focus of existing staff and by contracting for services, something we already do.

In conclusion, successful implementation of this strategy will:

- Enhance the performance of existing assets;
- Ensure that significant land holdings will be maintained in perpetuity, thereby providing a hedge against inflation;
- Optimize risk and return through diversification of holdings;
- Provide a more stable and predictable net revenue model that potentially doubles beneficiary distributions through immediate and sustainable income opportunities;
- Provide for appropriate and reasonable management expenses by focusing resources and maintaining solid business relationships.

RECOMMENDATION

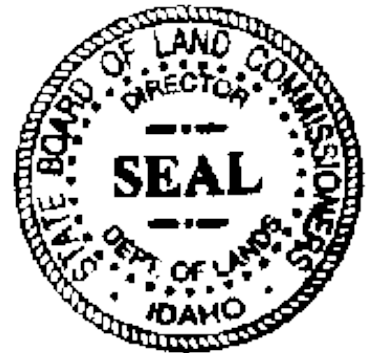
1. Direct the department to pursue a mid-term (10 – 20 year) strategy focused on developing and acquiring Commercial Income Producing assets as described above, and in geographically strategic locations and of institutional investment quality and quantity as determined by the department and the board.
2. Direct the department to continue activities under the approved Forest Asset Management Plan as necessary to protect the vital revenue stream provided to beneficiaries by the state's forest management.

BOARD ACTION

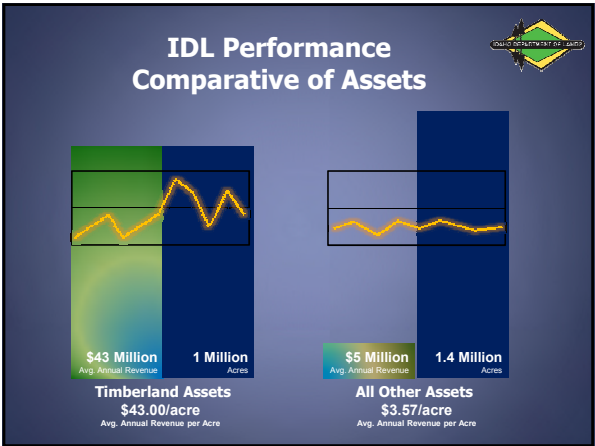
A motion was made by Attorney General Wasden to adopt the Department's recommendation as presented. Secretary of State Ysursa seconded the motion. The motion carried on a vote of 5-0.

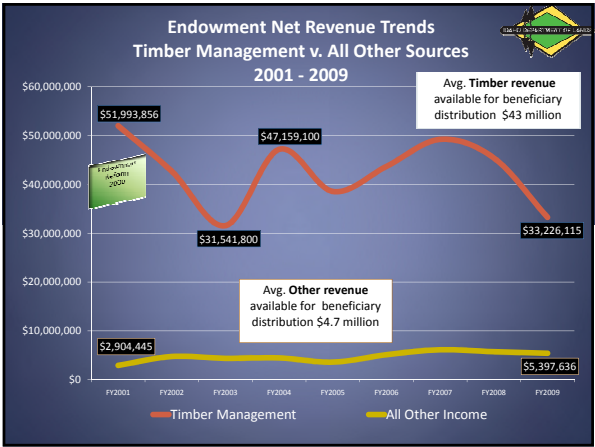
ATTACHMENTS

Attachment A - *Endowment Land Assets, Strategic Planning Vision*



ENDOWMENT LAND ASSETS
STRATEGIC PLANNING







ENDOWMENT LAND ASSETS
STRATEGIC PLANNING

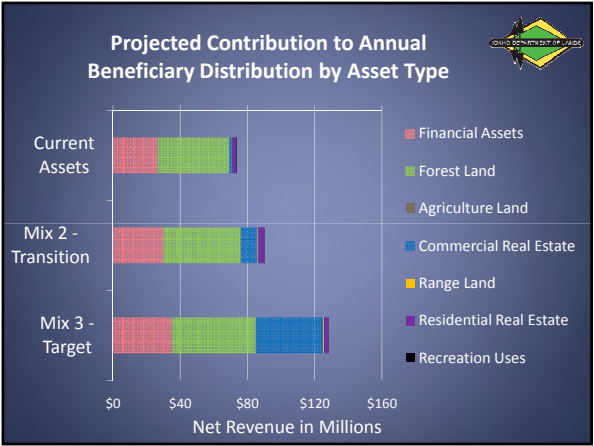
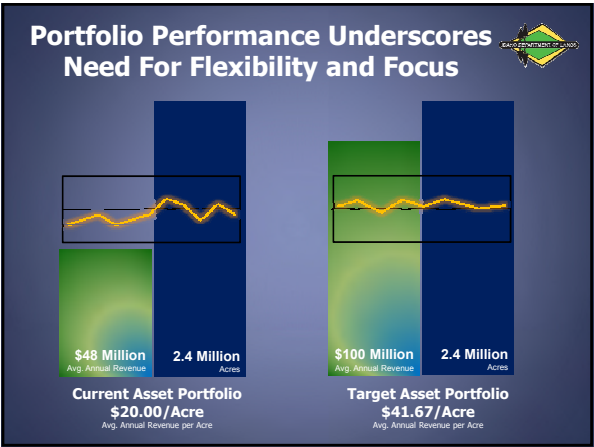
Why We Need Constitutional Changes

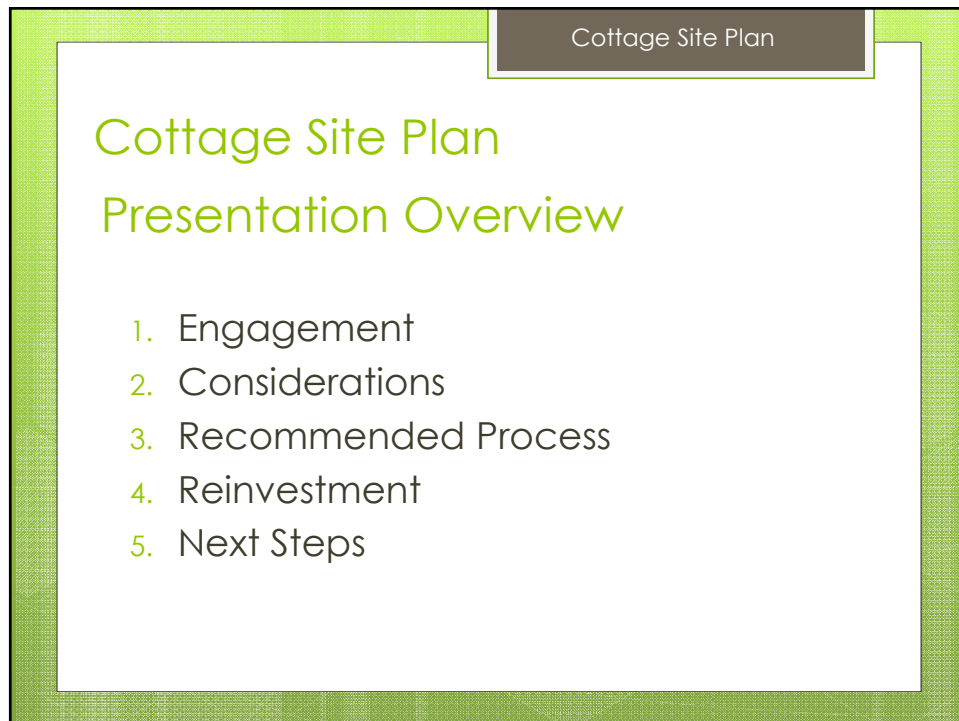
Aspects of the constitution granting language are not in keeping with modern business methods. Why is that a problem?

- ✓ Public auction requirements and acreage limitations are out of step with business transactions and reduce opportunities to add value for beneficiaries.
- ✓ The current structure makes it difficult to diversify investments which creates more risk to the endowment lands and their beneficiaries.

Potential Lost Revenue = 10-30% of transaction value









Engagement

Primary Objective

- Articulate a programmatic, “**market savvy**”, process for unifying the split cottage site estate.
- Identify the type of process that would be employed by a **prudent institutional real estate investor** seeking to maximize the long-term financial return to beneficiaries or shareholders.
- Explore processes for divesting of residential cottage sites and reinvesting in institutional grade real estate.

Considerations

1. Constitutional mandate
 - Maximizing the financial return to the beneficiaries
2. Land Board Strategic Vision
 - Consistent with adopted vision to diversify endowment portfolio

Cottage Site Plan

Considerations

3. Asset Performance
 - Returns are maximized by divesting of cottage sites and reinvesting
4. Market Timing
 - No financial advantage to delay
 - Significant market opportunity with current lessees

Cottage Site Plan



Recommended Processes

Disposition

Two Processes

- Consolidated Exchange (CE)
- Voluntary Rolling Auction (VRA)

Common Elements:

1. Modification of existing processes
2. Based on Appraised Value
3. Can start as soon as Lot Solutions Process is complete for each logical grouping of lots
4. Maximizes flexibility to both Lessees and IDL
5. Maximizes predictability for Beneficiaries, Land Board and Lessees

Consolidated Exchange (CE): Key Points to Make It Work

- IDL to control every aspect of the exchange process.
 - Timing
 - Asset types
 - Due diligence, analysis
 - Portfolio balance and reinvestment

CE Process: Considerations

Benefits

- Maximizes long-term return to beneficiaries
- Limits need for intermediaries
- Proactive and strategic targeting of new assets
- Predictability in cost and timing

Limitations

- Requires lessees to have cash or financing to complete exchange.

Voluntary Rolling Auction (VRA): Key Points to Make It Work

- Voluntary
- Methodical
- Efficient

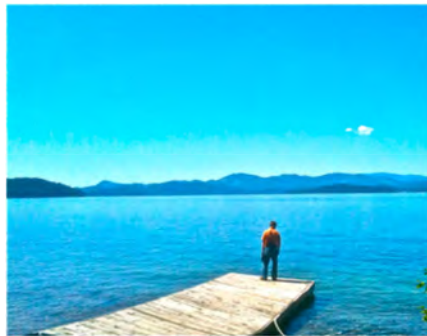
VRA Process: Considerations

Benefits

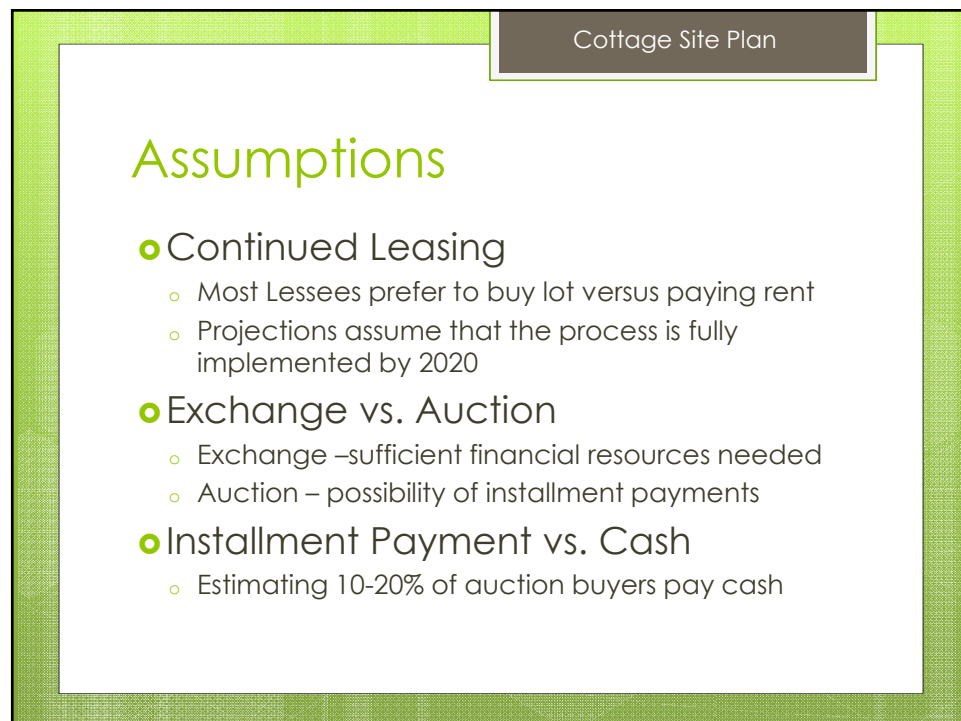
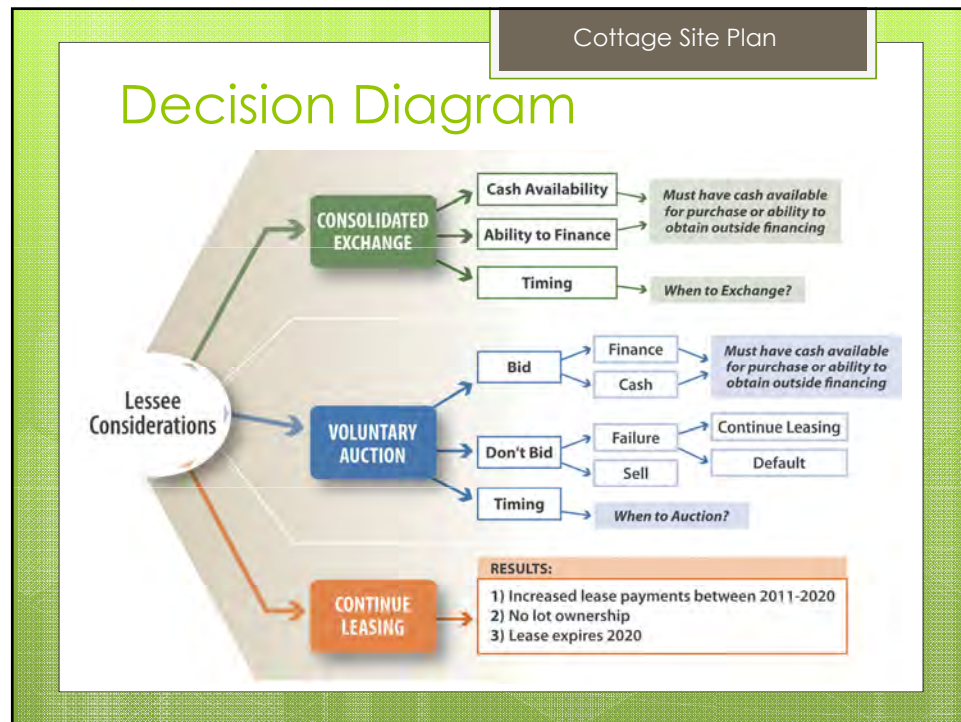
- Installment payments exceed current lease revenue
- Efficient opportunity for public to bid on properties
- Opportunity for lessees to purchase of lot with non-recourse installment payments

Limitations

- In the event of failed auction lessee must continue making lease payments and forfeit 1% fee
- Lessees face some interest rate risk when they refinance at end of installment payment term



Reinvestment



Cottage Site Plan

Assumptions

• Values & Economic Recovery

- Based on appraisals
- Policy decision is insensitive to market timing

• Reinvestment

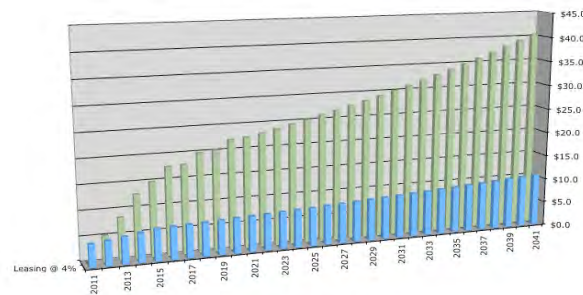
- Assumes a diversified portfolio of commercial RE
- Cap rates of 6-8% and average annual rent escalations of 4%
- Does not impact private activity and does not unfairly compete due to portfolio size

Cottage Site Plan

Comparison: Beneficiaries

Under even the most optimistic leasing scenario, the beneficiaries highest financial benefit results from implementing the disposition & reinvestment process


Beneficiary Net Cash: Cottage Leasing vs. Disposition-Reinvestment



-Continued leasing shown in blue.
- Reinvestment of proceeds from disposition of cottage sites shown in green.

Cottage Site Plan

Conclusion: Benefits



| | |
|----------------------|---|
| Beneficiaries | <ul style="list-style-type: none"> • Diversified Institutional-grade portfolio that provides for: <ul style="list-style-type: none"> • Increased Cash Flow • Long-Term Security |
| Land Board | <ul style="list-style-type: none"> • Consistent with constitutional mandate & fiduciary responsibility • Reduced Administrative Cost |
| Lessees | <ul style="list-style-type: none"> • Fee Ownership • Predictability |

Market based, value added solutions that benefit all stakeholders.

Cottage Site Plan

Next Steps

- Public Comment period
- Continue to implement Lot Solutions Process

