Responses to Governor Little's Questions Regarding Reinvestment of Land Bank Funds

(Questions are from notes and meeting minutes from the 7/19/19 reinvestment subcommittee meeting)

1. **It's interesting that TIMOs are divesting from Idaho rather investing.**

   TIMOs and REITs operate very differently from endowment timberland ownership and management. Basically, their strategy is to liquidate the timber asset and then sell the real estate. Much of the land available for sale retains very little merchantable timber, thereby making the land less valuable for acquisition for TIMOs and REITs. Conversely, the endowments can utilize the acreage with sub-merchantable trees to fill inventory gaps, making this timberland excellent for acquisition by the endowments who already hold billions of board feet of large trees.

   The Strategic Reinvestment Plan developed by Callan in 2016 addressed availability of potential transactions due to changes in the timberland sector as follows:

   > Market dynamics in the timberland industry include increasing transaction flow. There have been several large institutional portfolios of timberland brought to the market in the U.S. Several closed-end commingled funds are nearing their expirations, which will result in timberland for sale. Additionally, multiple timberland investment organizations are undergoing changes which could result in additional deal flow from manager disruption and terminated vehicles. The environment with substantial availability of properties for sale and projected to be for sale may help to moderate pricing. The availability of transactions is in marked contrast to prior years and the Land Board should take advantage of the increased transaction flow.
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   > In the early 2000's there was a high level of commitment activity to U.S. focused timberland funds. Many of these funds have reached the end of their legal life and still have remaining timberland assets to be sold. Given the challenges in the recent market cycle and the long term nature of the timberland asset class and timber lifecycle, the ten year life has proved an insufficient time frame to roundtrip a strategy and exit all assets. As a result there are many groups of fund investors determining extension provisions for their funds and a certain level of dissatisfaction or frustration with the lack of disposition activity to date.
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   > Based on information from a recent timberland request for information, Callan estimates that there is $9.5 billion in timberland commingled fund holdings that are currently within two years or beyond the legal fund term life. The expiring funds may result in a fair amount of investment opportunities coming to market.

2. Why is concentration in Idaho timberland a good thing?

The Strategic Reinvestment Plan described the advantages that the Land Board has related to timberland investment and the rationale supporting additional investment in timberland:

> Callan believes that the Land Board has a competitive advantage in timberland investing compared to other institutional investors and owners of timberland given its experienced Staff, existing portfolio, long term investment horizon, and cost of capital. (IDL note: The endowments also have an inventory advantage that makes acquisition of acreage primarily consisting of sub-merchantable trees desirable.)
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> Investment in additional timberland is a way to replace lost income from the sales of cabin sites and commercial real estate.
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> Additional investment is supported by the asset allocation study which indicates portfolio risk/return will be maintained with additional investment in timberland provided new investments have a net projected return at or above the returns of the existing portfolio with a similar level of risk. In Callan's study, the existing timberland portfolio had an expected net 10 year compounded return of 5.70% (3.45% net real return). The recommended Hurdle Rate for Timberland is a minimum net real return of 3.5% which equates to a 5.75% net nominal return, assuming 2.25% inflation. The risk profile of each transaction and market dynamics will dictate the return that will be required, such that some transactions may have returns above the Hurdle Rate.
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> Callan does not recommend setting a hard target for the amount of dollars to be invested, but rather allowing the investment decision to be driven by the opportunities. The range for timberland is 30-50% of the total Endowment portfolio. If attractive opportunities are found, all of the projected proceeds in the Land could be invested in timberland and timberland would remain in the target 30-50% range, assuming the total portfolio remains at or above the current value.
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> This is an unusual time for the Endowment due to the amount of disposition activity taking place. Based on the current Asset Management Plan, it does not appear that after FY 2020, there will again be the level of proceeds to invest in Land. Therefore, the Land Board should consider using Land Bank proceeds to invest in Timberland and Farmland, provided the targeted Hurdle Rates can be met or exceeded and an institutional investment process is used.

The following excerpts are from a Callan research publication entitled "*The Triple Play – Adding Timberland, Farmland, and Infrastructure to Portfolios"*:

> Adding timberland, farmland, and infrastructure is beneficial for the portfolio mix of many investors. Real assets such as these provide diversification, stable income, and inflation protection, and they pair well with an established real estate portfolio.

Timber, farmland, and infrastructure assets differ in many regards, of course. But as investments they share some common features:

Low correlations to traditional asset classes contribute to diversification potential

- Stable and predictable income factors prominently into returns
- Inflation hedge
- Expanding global investment opportunity set
- Strong long-term demand drivers in both developed and emerging markets

These assets generally show low correlations to traditional asset classes (i.e., equities and fixed income), as well as to public and private real estate (**Exhibit 1**). This makes them powerful diversifiers for the total portfolio and within a real assets-only portfolio.

Exhibit 1

The Big Picture on Correlation

(periods ended 3/31/17)

5-Year Correlations / 10-Year Correlations

	U.S. Private Real Estate	Private Farmland	Private Timbeland	U.S. REITs	Commod.	Listed Infra.	U.S. Stocks	U.S. Fixed Income	Inflation
U.S. Private Real Estate	1.00	0.04	0.20	0.23	0.21	0.20	0.24	-0.19	0.27
Private Farmland	0.16	1.00	0.58	-0.13	-0.13	-0.04	0.05	-0.10	-0.46
Private Timberland	0.20	0.91	1.00	-0.24	-0.16	-0.21	-0.20	0.12	-0.22
U.S. Public Real Estate (REITs)	0.17	0.23	0.28	1.00	0.39	0.70	0.76	0.02	0.25
Commodities	-0.39	-0.25	-0.29	-0.10	1.00	0.65	0.55	-0.11	0.63
Listed Infrastructure	-0.34	0.05	0.04	0.37	0.54	1.00	0.84	0.08	0.36
U.S. Stocks	-0.28	0.32	0.27	0.14	0.29	0.53	1.00	-0.30	0.30
U.S. Fixed Income	0.07	-0.14	-0.05	0.60	0.14	0.54	-0.19	1.00	-0.23
Inflation	-0.19	-0.60	-0.66	-0.07	0.70	0.46	0.13	0.15	1.00

Indices Used: U.S. Private Real Estate (NCREIF Property Index); Private Farmland (NCREIF Farmland Index); Private Timberland (NCREIF Timberland Index); U.S. Public Real Estate REITs (FTSE NAREIT Equity REITs Index); Commodities (Bloomberg Commodities Index-Total Return); Listed Infrastructure (Dow Jones Brookfield Global Infrastructure Index); U.S. Stocks (Russell 3000 Index); U.S. Fixed Income (Bloomberg Barclays US Aggregate Bond Index); Inflation (CPI-U).

Sources: Bloomberg, Bloomberg Barclays, Bureau of Labor Statistics, FTSE Russell, NCREIF, Russell, S&P Dow Jones.

IDL operates an efficient timber program on behalf of the endowments. Over the last five fiscal years, the average net income from timberland was $43.98 million on gross revenue of $65.98 million, resulting in an average net income ratio of 66.7%. The Department has established a goal of improving the overall net income ratio for all land assets to at least 67% (five year rolling average) by 2025. The current five year average net income ratio for all land assets is 63.5%.

With the disposal of commercial real estate and cottage sites, which were significant revenue sources, the timberland asset class is under increasing pressure to improve performance in order for the Department to meet the net income ratio goal. In effect, timberland must over-perform to offset poorer performance from other asset classes.

Because the productivity of endowment timberlands will allow it, the Department is recommending a 32.8% increase in annual timber sale volume from the existing land base. The recommendation is made in the long term best interest of the endowments and the endowment timberlands. Assuming stable prices and markets, based on five year average gross income, the endowments could expect an increase of about $21.6 million in gross income from the timberland asset. The increased revenue will not have a proportional spending increase. Once the annual sale volume is fully implemented, timberland is expected to exceed the net income ratio goal, demonstrating increasing efficiency.

The timber program is scalable and can efficiently manage additional acreage. With additional reinvestment, the Department would not expect an increase in administrative staff, although addition of a small number of field staff could be needed. The Department believes that additional acreage would further improve the financial efficiency of the endowment timber program.

Endowment timberlands provide long-term benefits for public recreation, increased local school distributions, stability of ownership, and support for local jobs. In contrast, potential acquisitions by non-timber producing landowners may produce different outcomes in terms of development, land use restrictions, recreational access, stability, and economic outputs.

Endowment ownership provides economic stability and provides benefit to the public through typically open access for public recreation. Timberland acquisition is consistent with the constitutional mandate to maximize long-term revenue for the endowment beneficiaries.

3. How does our timberland ownership (and acquisitions) line up with mill infrastructure?

The evaluation of potential timberland acquisition includes a review of the proximity to timber markets and mill infrastructure. The interest in acquisition is limited to areas where markets are expected to remain strong (as a very general description - north of the Salmon River). Exceptions may be considered if the acquisition would help resolve another issue, such as access to a significant block of endowment land which may make an acquisition outside of the preferred area economically viable.

The Department has established basic evaluation criteria for potential land acquisitions. The criteria are a means of screening transactions so that staff time and resources can be utilized on the most promising potential acquisitions. The criteria include:

- Strong market areas and proximity to mill(s)
- No known political or regulatory issues
- Expected to exceed the required financial hurdle rate
- No/minimal T&E species concerns
- Manageable forest health, no known regeneration issues
- Operability – prefer all season, limited to one season is a concern
- No known environmental or boundary issues
- Minimal Highest and Best Use (HBU) values (not in the path of immediate development)
- Desirable aspect/elevation range
- Lawful permanent access
- Proximity to good transportation system
- Sufficient size
- Proximity to endowment land

Potential acquisitions that pass the initial screening are analyzed rigorously, including financial analysis, to determine suitability for purchase by the endowments.

The endowments own some of the most productive timberlands in the inland northwest. Factors including quality of soils, precipitation and variety of tree species contribute to the high quality, productivity, and resilience of endowment timberlands. Endowment lands produce about 25% of the volume harvested in Idaho despite being only 2.6% of the timberland. The current endowment timberland portfolio is mostly positioned well relative to markets/mill infrastructure. Most of the major mill infrastructure is located within a two hour haul distance of endowment timberlands in north and central Idaho. Timber sale auctions often include competitive bidding. Under the 2019 Forest Asset Management Plan, over 60% of the annual sale volume comes from the Department's North Operations region in central and north Idaho. However, timber sales in Southern Operations continue to sell and are rarely in a no-bid situation.

4. Where are we on ag land moving forward?

The Department has evaluated several potential farmland acquisitions. To date, the Department has not been able to pursue farmland acquisition because transaction level analysis did not show that the acquisition would exceed the required 4.5% net real return on investment without including the disposition value in 10-20 years.

5. Acquisition of isolated parcels might not make sense.

The Department's acquisition criteria prioritize parcels that are adjacent to existing endowment lands. Alternatively, stand-alone parcels of sufficient size with legal access may be suitable for acquisition. Also, an isolated parcel that would secure access to endowment lands may be appropriate for acquisition if the financial analysis provides justification.

6. Timing for asset investment is key.

This is true for any investment whether in real assets or financial assets. Timing any market effectively is difficult. The five year Land Bank period provides some flexibility to allow for opportunistic acquisitions although there may be opportunity cost associated with delay as well.

The Department analyzes any potential acquisition based on the economic factors at that time, including current timber prices. The Department, on behalf of the endowments, will not always be the high bidder for a potential acquisition. If the potential acquisition does not meet the established hurdle rates, or if the price is too high, the Department will not proceed with the acquisition. This occurred with a potential large acquisition in North Idaho where the Department could not compete with other bidders.

7. **Good neighbor is a good thing but also a concern in terms of additional fiber on the market and potential impact on endowment timber prices.**

   Idaho is currently a net importer of timber to supply the existing mill infrastructure. There is room in the market for additional federal timber without impacting the market for endowment timber. There are likely to be short-term market related issues that will decrease endowment stumpage prices at times. Short-term market issues may not be indicative of competition from federal sales. Increased Federal management will also help maintain intermixed cooperatively managed transportation infrastructure which will ultimately decrease expenses for the endowments.

   The vast majority of endowment lands share a boundary or are in close proximity to federal lands. Increased active management on federal lands will have long term forest health benefits for endowment lands. It could also help sustain the forest products industry in Idaho, which has clear long term benefits to the endowments. If the federal supply became sufficient and reliable, perhaps investment in mill infrastructure could occur in some locations.

8. **Should we put it all into timberland or split and put some into the financial side?**

   During their presentation (September 2019) as a candidate for investment consultant for the Endowment Fund Investment Board (also for the Land Board/Department of Lands and the State Insurance Fund), the firm RVK provided analysis of the EFIB financial portfolio based on their capital markets assumptions using Monte Carlo simulation. The analysis showed, over a ten year period, a 54% chance of achieving at least 3.0% real return, a 43% of achieving at least 4.0% real return, and a 34% chance of achieving at least 5.0% real return from the financial portfolio.

   Timberland acquisition using a hurdle rate (minimum net real return) of 3.5% would provide returns comparable to the expected performance of the financial assets over time.

   The excerpts below are from the July, 2018, Land Board approval of its Investment Subcommittee's recommendation regarding reinvestment of land bank funds:

   > In August 2017, as directed by the Idaho State Board of Land Commissioners (Land Board), the Secretary of the Land Board entered into a contract amendment with Callan Associates (Callan) to conduct an Asset Allocation and Distribution Study (Study). The Study was intended to provide further analysis and refinement on previous asset allocation work completed by Callan in 2014. One primary goal of the Study was to determine for each endowment the best and highest use of assets in the Land Bank—reinvestment into traditional land assets (timberland or farmland) or transfer to the financial asset portfolio.
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   > The Land Board's Investment Subcommittee (Subcommittee) was tasked with reviewing the final Study results related to Land Bank proceeds, including the options outlined for

Land Board consideration, before making a formal recommendation to the Land Board in July. This timeline coincides with the annual update to the Statement of Investment Policy and Strategic Reinvestment Plan.

The "Land Board Options to Consider" outlined on page 33 (Attachment 1) of the Callan Study read:

- Option A – Consistent with the Reinvestment Plan, identify potential transactions that meet established hurdle rates and set aside sufficient funds over appropriate time horizon (immediately move money that will either "mature" prior to the transaction or exceeds what is required).

- Option B – Move land sale proceeds that are set to expire in calendar years 2020-2021 (approximately $58 million) into the Permanent Fund with the remainder contingent on IDL identifying land acquisitions consistent with the Strategic Reinvestment Plan.

- Option C – Immediately transfer all Land Bank funds to the financial asset portfolio.

The Subcommittee thoroughly vetted the Study results, options outlined, and associated plans and voted on June 12, 2018, to accept the Study as completion of the general consultant contract amendment and to recommend the Land Board pursue Option A for the following reasons:

- 2017-2018 Study results are consistent with the 2014 Callan Study and the 2016 Strategic Reinvestment Plan (Attachment 2), which confirms Department activities are properly aligned with established goals and governance;

- Land Bank reinvestment is the only mechanism for recovering land assets and associated revenue (lost as result of cottage site and commercial property sales), which is necessary to reduce risk in the land base, balance risk in the overall endowment portfolio, and help grow revenue with inflation and population growth;

- A pipeline of potential land acquisitions has been developed by the Department with several acquisitions slated for close as early as calendar year 2018;

- Callan's model was based on the minimum hurdle rate of 3.5% return on asset but potential acquisitions under review by the Department are likely to bring higher levels of return and lower levels of volatility, which makes land acquisition more favorable than investment in the financial portfolio;

• The Department and EFIB are already closely monitoring Land Bank funds and intend to proactively initiate Land Bank transfers to the Permanent Fund when necessary; and

• The Department's Acquisition Business Plan, initiated after Land Board approval of the Strategic Reinvestment Plan in 2016, aligns with implementation of Option A as well as Land Board-approved governance documents, including the Statement of Investment Policy, Asset Management Plan, and Strategic Reinvestment Plan.

Also in July, 2018, the Strategic Reinvestment Plan was reviewed by the Land Board. The following are excerpts from the approved memo:

> Callan, the Idaho Department of Lands (Department), and Endowment Fund Investment Board (EFIB) completed the asset allocation/spending study over the past year. Results presented by Callan in April indicated findings are consistent with previous studies and the Strategic Reinvestment Plan approved in 2016. Callan concluded investment of Land Bank proceeds in timberland or farmland is appropriate for all endowments provided acquisitions meet or exceed established hurdle rates.
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> For the 2018 update of the Strategic Reinvestment Plan, Callan issued a memo to the Land Board dated July 5, 2018 …, which acknowledges the results of the asset allocation/distribution study, provides updated discussion on the hurdle rates for timberland and farmland acquisitions, and recommends continued implementation of the Strategic Reinvestment Plan approved in 2016. The memo specifically states:
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> > The findings from the Asset Allocation and Distribution Study completed by Callan in 2018 are consistent with the conclusions and next steps outlined in the Strategic Reinvestment Plan approved by the Land Board in 2016. Assuming the Land Board adopts the recommendation of the Investment Sub-committee to proceed with Option A1 of the Asset Allocation and Distribution study, Callan recommends that all future investments in timberland and farmland are made at or exceed the established hurdle rates. This applies to all endowments.

9. What happens at the end of the road for cottage sites? The easy ones have been sold.

The current leases expire at the end of 2024. The Department intends to work with the Land Board to determine a path forward for Land Board approval in advance of the lease expiration date.

10. What is the basis for the real estate values established by IDL? Has the Land Board provided a standard for land valuation for the Department?

The Land Board accepted the Callan report in 2014, thereby providing guidance to the Department regarding certain land valuations. In the report, Callan supports a discounted cash flow/income approach for rangeland and timberland using an independent advisor.

The asset allocation study valued timberland at $1.14 billion and rangeland at $61 million in 2014 (analysis completed in 2013). The study did not value farmland, which it termed "de minimis holdings." The valuations for rangeland and timberland have not been updated.

The Department does not dictate how an appraiser defines market value to value a property. All appraisals must adhere to Idaho appraisal rules and laws (eg. I.C. § 54-4101 *et seq.*). At times, the Department will meet with the appraiser and address issues that may need to be resolved through appropriate appraisal methods, such as hypothetical conditions or extraordinary conditions. In many cases, an appraisal review and third party pre-qualified expert review is completed as part of the process.

Valuations vary based on the transaction type. For example, grazing leases are based on the Land Board established grazing rate. However, the valuation for the sale of grazing land would be based on the appraised value of the land. The following is a brief outline of appraisal and valuation methods used by the Department:

- Rules and Statutes:
  - 47-704 Leases of Mineral Rights in State Land
  - 54-4101 Idaho Real Estate Appraisers Act.
  - 58-133 Acquisition, Sale, Lease, Exchange or Donation of Public Lands – Creation and Operation of Land Bank Fund.
  - 58-138 Exchange of State Land.
  - 58-301 Appraisement – Fee – Reappraisement – Appropriation for Appraisement.
  - 58-304 Leases.
  - 58-313 Sale of State Land.
  - IDAPA 20.03.08 Easements on State Owned Lands
  - IDAPA 20.03.13 Administration of Cottage Site Leases on State Lands
  - IDAPA 20.03.14 Rules Governing Grazing, Farming, Conservation, Noncommercial recreation, and Communication Site Leases
  - 20.03.15 Rules Governing Geothermal leasing on Idaho State Lands
  - 20.03.16 Rules Governing Oil and Gas Leasing on Idaho State Lands

- Transaction types:
  - **Rights of Way (easements)**: IDAPA 20.03.08.021.02 compensation is based on the encumbrance. The valuation method is based on use and damages to the property. An appraisal may be required if the easement value exceeds the minimum compensation fee of $500. The appraisal will be performed by qualified department staff or a licensed Idaho appraiser. IDAPA provides compensation valuation based on certain easements.

- **Dispositions**: Article IX, Section 8 of the Idaho Constitution: "provided, that no state lands shall be sold for less than the appraised price."
    - Cottage sites are valued by appraisal using a comparable sales approach.
    - Commercial buildings are valued by appraisal using an income approach and/or comparable sales data.
    - Rangeland is valued by appraisal using a comparable sales approach.
    - Timberland is restricted from sale, see I.C. § 58-133.

- **Acquisitions**: Callan recommended return hurdle rates must meet or exceed 3.5% net real for timberland and 4.5% net real for farmland. Again, the Department has not purchased any farmland with Land Bank funds. All acquisitions are reviewed prior to closing by an independent third-party expert.

- **Asset Valuation**:
    - Farmland - Valued using National Agriculture Statistics Service data for dry farmland and is updated annually. Farmland acquisition valuation involves both comparable sales and income approach.
    - Timberland – The last valuation of timberland (2013) utilized the land expectation value method (LEV). LEV is based on a forecast sustainable real cash flow that will exist into perpetuity. This cash flow was discounted by a constant discount rate (4%).
    - Rangeland - The last valuation of rangeland (2013) also utilized the land expectation value method based on a forecast sustainable real cash flow that will exist into perpetuity. This cash flow was discounted by a constant discount rate (1.25%).

- **Land Exchanges** – Idaho Code § 58-138: an appraisal and review appraisal is conducted of the lands proposed for exchange. All such appraisals and review appraisals are performed by appraisers who are licensed or certificated to perform such work in accordance with chapter 41, title 54, Idaho Code, and are designated as members of the appraisal institute (MAI). All appraisals and review appraisals shall conform to the uniform standards of professional appraisal practice (USPAP) standards.

- **Leases**:
    - Commercial office / retail: local market rate
    - Commercial ground: percentage of appraised value
    - Grazing: Land Board approved grazing rate. IDAPA 20.03.14.040 - the methodology used to calculate rental rates shall be determined by the Board.
    - Telecommunications: Land Board approved usage type rate. IDAPA 20.03.14.040 - the methodology used to calculate rental rates shall be determined by the Board.

- Cottage sites: IDAPA 20.03.13.025 – Annual rental shall be set by the Board. The current yearly rental rate is a percentage (4%) of appraised value. Appraisals are performed every five years.
- Mineral Leases: 47-704 – the LB may lease state lands for such annual rental, not less than one dollar ($1.00) per acre per year, except in the case of state oil and gas leases wherein the royalty to the state shall be not less than twelve and one-half per cent (12 1/2%), and provided that the minimum royalty shall not be less than two and one-half per cent (2 1/2%).
- Oil and Gas: IDAPA 20.03.16 – The lessee shall pay to the state annual rental for each lease three dollars per acre with a minimum of $250 per lease.
- Geothermal: IDAPA 20.03.15.035 – Annual rentals will be set by the Board through competitive bidding, negotiation, fixed amounts, formulas, or some other method of valuation which a prudent investor might reasonably apply to establish such rental amounts.